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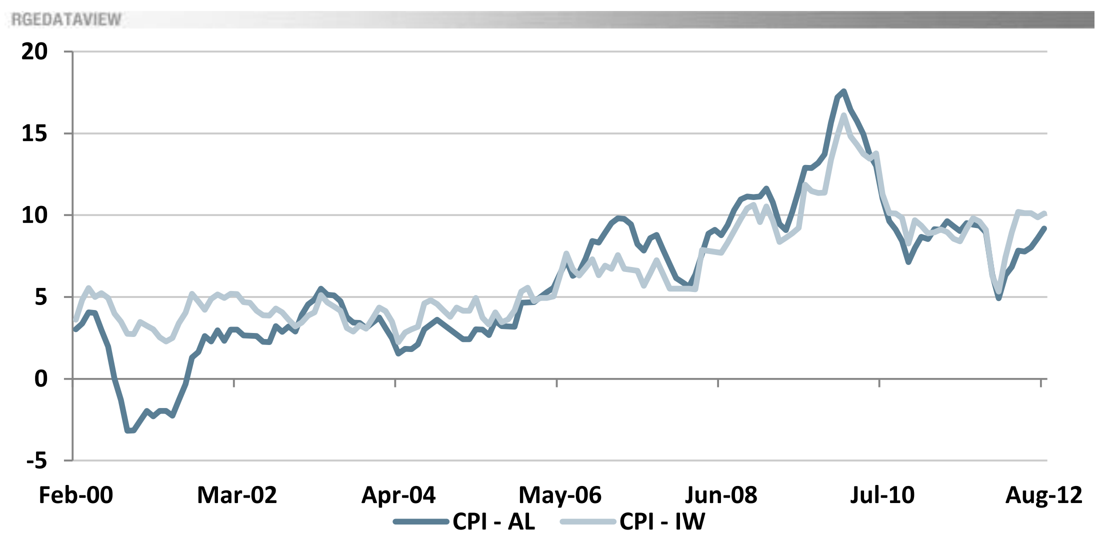
Food Inflation in India – Government Has to Act, Not hope

By Kunal Kumar Kundu

Inflation, especially food inflation in India remains essentially a government monopoly. Surprised? What I mean is that high food inflation is the cause of faulty government policies that has a distortionary effect on prices.

Given the elevated level of food prices in urban India, the common perception is that urban inflation is higher than rural inflation. The data, however, bears out a different story.

Figure 1: CPI (% y/y) Inflation Higher in Rural Areas Than Urban Areas



Note: AL – Agriculture Labour, IW – Industrial Worker
Source: Government of India, RGE

As the chart above shows, rural inflation started to trend upward from 2006 onward and remained above urban levels or at par.

This coincides with two major decisions embarked upon by the ruling government in 2006 – implementation of MGNREGA scheme (which the government believes brought them back to power in 2009) and a massive spurt in MSP (Minimum Support Price) from 2006 onward.

MGNREGA: It is the acronym for Mahatma Gandhi National Rural Employment Guarantee Act. This was touted as the flagship scheme UPA government. The Act was notified during 2005 (FY06) and became operational during FY07. The objective of the Act is to enhance livelihood security in rural areas by providing at least 100 days of guaranteed wage employment in a financial year to every household whose adult members volunteer to do unskilled manual work. Works would include creation of rural infrastructure like roads (not covered under PMGSY or Pradhan Mantri Gram Sarak Yojna i.e. Prime Minister Rural Road Scheme), irrigation canals, land development etc.

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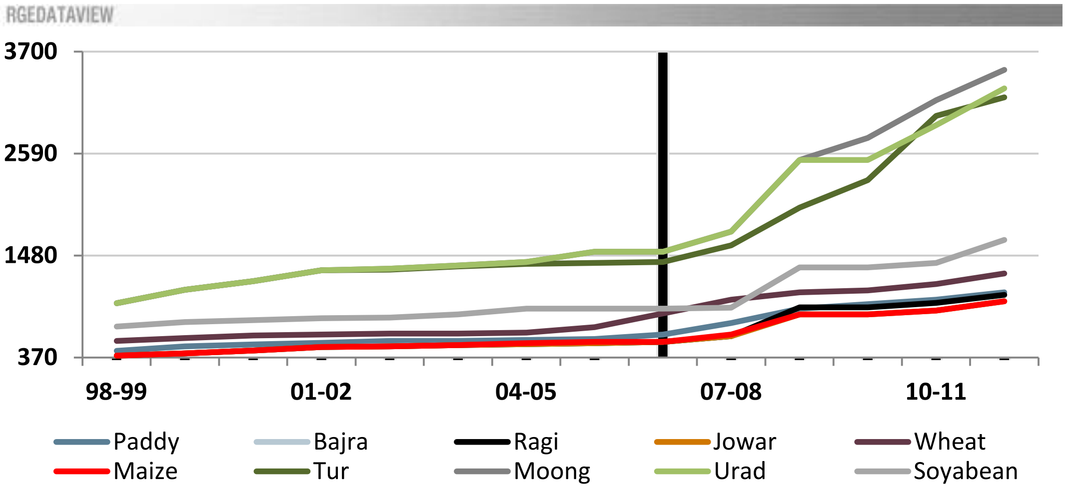
The Act was notified in 200 districts in the first phase with effect from February 2nd 2006 and then extended to additional 130 districts in the financial year 2007-2008 (113 districts were notified with effect from April 1st 2007, and 17 districts in UP were notified with effect from May 15th 2007). The remaining districts have been notified under the MGNREGA with effect from April 1, 2008. As per the Act, work should ordinarily be provided within 5 km radius of the village. In case work is provided beyond 5 km, extra wages of 10% are payable to meet additional transportation and living expenses.

There's no doubt that the goal of MGNREGA is commendable. For a country like India with a vast multitude of rural population living in abject poverty, schemes of this nature play an important role in eradicating poverty. It aims to provide guaranteed employment to rural poor while helping create assets for sustainable development. As per available data, the total expenditure on the scheme during FY07 was INR 88.23 billion. As the coverage continued to increase, the expenditure rose exponentially. By FY12, it rose nearly 3.5 times to INR 292.15 billion. While the scheme can be touted as being successful due to increasing coverage (read large number of beneficiaries), hardly any rural infrastructure creation took place, save for a few exceptions. Essentially it became a way of transferring cash without any capacity creation.

Minimum Support Price (MSP): MSP is used as a tool to incentivize farmers to produce foodgrains and help them during period of crop failures. However, like all other social sector spending, it has become a tool to appease the farmers whose vote counts big during elections. While MSPs are supposed to be used as a tool to compensate farmers especially during periods of stress (which means that during normal periods, MSPs ought to be lowered or even stopped), in reality MSPs in India has always moved in one direction, viz upward.

The continuous upward trend in MSPs, create distortion in the market. There has never been even a single instance when specific hikes in MSP (say drought relief, or bonus to meet specific procurement targets etc) have been withdrawn next year. Rather, these act as a floor for prices in the next year. From end 2006 onward, substantial hike in MSP was announced in paddy and wheat and this was followed by steep across the board hike next year. From then on, MSPs have been rising very fast. While, between 1989-90 and 2006-07, the MSPs have increased between 2.5% and 6% p.a., it rose between 9% to 19% p.a. between 2006-07 and 2011-12. As MSPs form the benchmark for market prices, these tend to remain elevated even if the demand-supply dynamics require prices to come down. This clearly imposes inflationary pressures.

Figure 2: Trend in MSP Over the Years (Rs./tonne)



Source: Government of India, RGE

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Government procurement

Rising MSP and aggressive procurement by FCI has led to virtual government monopoly in food grain procurement, leading to ever rising food grain stock.

Figure 3: Public Distribution System – Procurement & Offtake (mn tonnes)

Year	Procurement			Offtake			Stocks		
	Rice	Wheat	Total	Rice	Wheat	Total	Rice	Wheat	Total
2004-05	24.04	16.80	**40.83**	23.20	18.27	**41.47**	13.34	4.07	**17.97**
2005-06	26.69	14.79	**41.48**	25.08	17.17	**42.25**	13.68	2.01	**16.62**
2006-07	26.30	9.23	**35.53**	25.06	11.71	**36.77**	13.17	4.70	**17.93**
2007-08	26.29	11.13	**37.42**	25.22	12.20	**37.43**	13.84	5.80	**19.75**
2008-09	32.84	22.69	**55.53**	24.62	14.88	**39.50**	21.60	13.43	**35.58**
2009-10	32.59	25.38	**57.98**	26.89	21.97	**48.86**	26.71	16.13	**43.36**
2010-11	31.13	25.92	**56.79**	29.80	23.07	**52.87**	28.82	15.36	**44.35**
2011-12	37.91	28.33	**66.35**	32.12	24.16	**56.28**	33.35	19.95	**53.44**

Source: Reserve Bank of India

By September 1, 2012, India's food grain stock swelled to 71.8 million tonnes (mt), which is more than double the required buffer stock norm. As per government rules, the strategic and buffer stock of wheat and rice in the country by June 30 should be 31.9 mt, which includes 26.9 mt as buffer stock and another 5 mt as strategic reserve.

While high MSPs keep the vote bank happy at the cost of inflation, it leads to additional distortion in that, the procurement policy does not address changing consumption pattern within the economy. As per the 2012 survey by NSSO (National Sample Survey Organization), between 1987-88 and 2009-10, for the poorest among poor (bottom decile), cereals account for more than 30% of the food expenditures (36.3% in rural and 30% in urban areas), while in case of rich people (top decile), cereals account for less than 20 per cent of food expenditure (16.2% in rural and 11.50% in urban areas). On the other hand, share of high value products, namely, livestock and fruits and vegetables is high, 46.6% in rural areas and 44.6% in urban areas.

High procurement also stretches the storage capacity of food grains in the country. Physical constraints are getting more glaring with rising food grain buffer. This is far higher than covered 32.1mt capacity of FCI (Food Corporation of India), 10 mt of Central Warehousing Corporation (CWC) and additional 30mt storage capacity at state levels. The key concern is that the total covered storage capacity is only around 50mt implying that nearly 22mt of food grain lie in an exposed state and hugely prone to damage. The amount of food grains damaged every year due to inadequate storage capacity is humungous.

Nevertheless, virtual government monopoly in procurement of food grains has resulted in nearly 70% of warehousing capacity being government owned. However, in case of perishable items like fruits and vegetables, cold storage facility is virtually privately owned and the total cold storage capacity is about a quarter of food grain storage capacity. Inadequate cold storage facility and even more inadequate power supply situation leads to higher level of wastage of such perishable items. This leads to inordinately high volatility in prices of perishable items. In fact, while the standard deviation of Headline WPI inflation during Apr'05-Aug'12 was less than 5 that of fruit and vegetables was close to 9, with only vegetables recording a standard deviation of more than 18.

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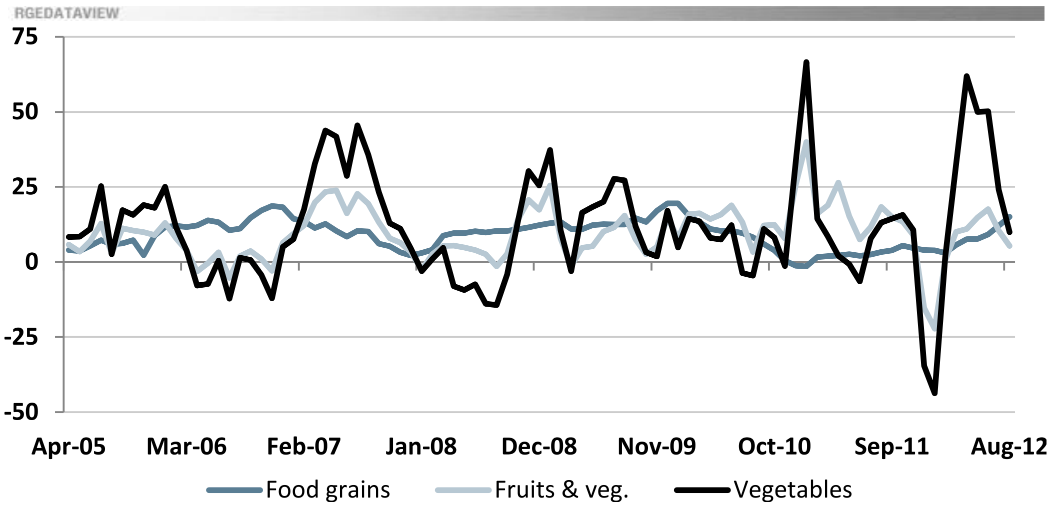
Figure 4: WPI (% y/y) Inflation of Perishable and Non-perishable Food Items

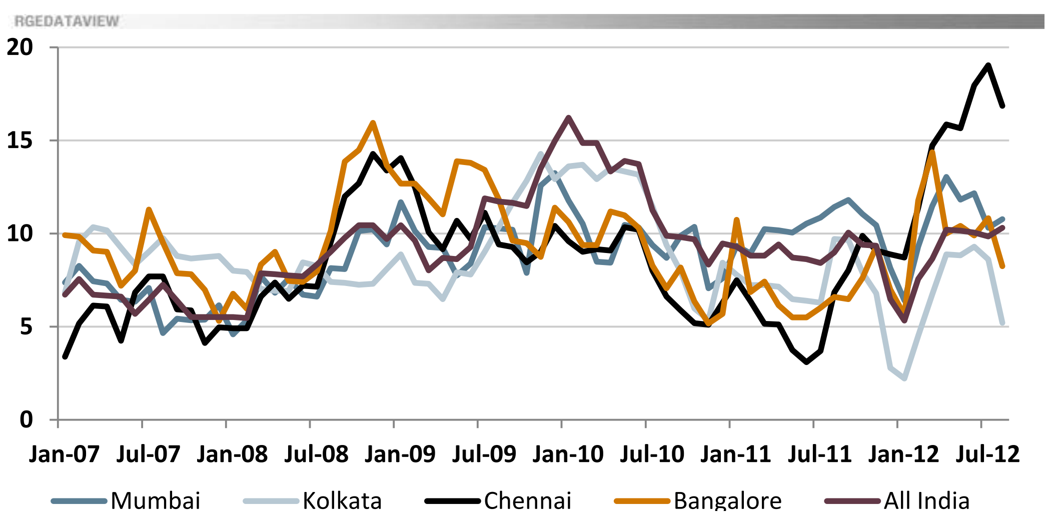


Source: Government of India, RGE

What is even more disconcerting is that, despite having huge stock of food grain, the government is unable prevent hoarding and speculative activity. Following the drought condition, the inability of the government to intervene in the market at appropriate time has resulted in food grain inflation during Jul'12 and Aug'12 jumping to 12% and 15.1% y/y respectively, entering into double digit for the first time since Jun'10 - a clear indication of failure of government machinery, even in times of crisis.

Having failed to rein in the inflation, the government is now hoping that FDI in multi-brand retail will be the panacea for India's food inflation woes. However, India's experience with domestic retail does not offer much hope. The domestic retailers have failed to build up necessary infrastructure, apart from setting up a few collection centres. Not surprisingly, CPI inflation in metro cities (which are the pre-dominant hunting grounds of domestic retailers) continues to rule well above the all India urban average.

Figure 5: City-wise Trend in CPI-IW



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While foreign investment in retail (which stipulates 50% FDI allocation in creating back end infrastructure, read cold storage chains) might help, overall conditionality might be a hindrance against inflows. It is also important to note that given various policy constraints and a highly fluid political environment, the presence of foreign retailers would be restricted to a few large urban areas only and hence, unlikely to make much dent to overall food inflation. The problem of food inflation in India goes beyond simple lack of cold storage facilities. It is policy induced, wherein recurrent populist measures in the garb of social sector spending are sought to be met with non-recurrent revenues leading to debilitating fiscal imbalance.

Fact is that, despite the presence of multiple middlemen (which leads to substantial distortion between price received by a farmer and price paid by an urban consumer), it is the rural inflation that remains high. The recent easing of rural inflation has to do with falling rural income due to drought. However, by the time 2013 arrives, rural inflation will spike up again because:

- With an eye to the 2014 general election, the government would ensure that the proposed and (highly) expensive Food Security Bill will become a reality
- MSPs will continue to rise
- Government spending on MGNREGA will also spike up – this being their holy grail

Result? Deficit will go up once more. This will lead to axing of capital expenditure. Hence, inflation will continue to remain a structural issue. Only solution would be strict adherence to fiscal consolidation – a la Kelkar Committee recommendations. However, politics will ensure that the only visible solution will not be a desirable one, not at least till 2014.

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