Unexpected Inflation*

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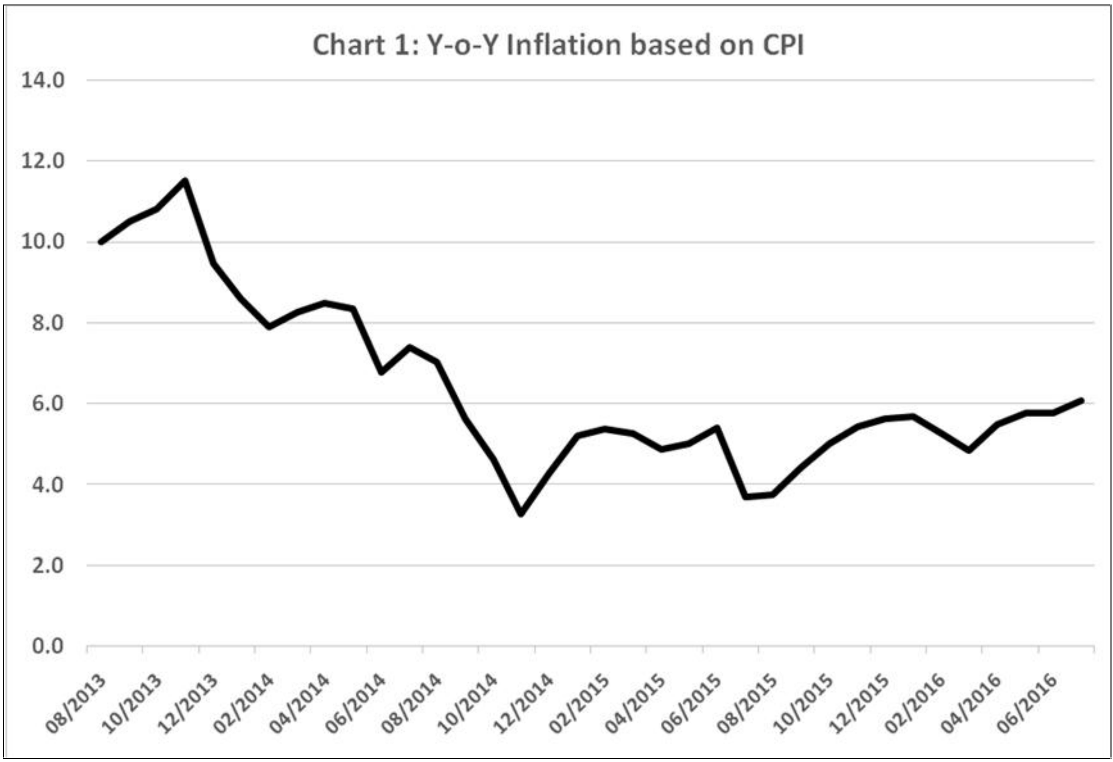
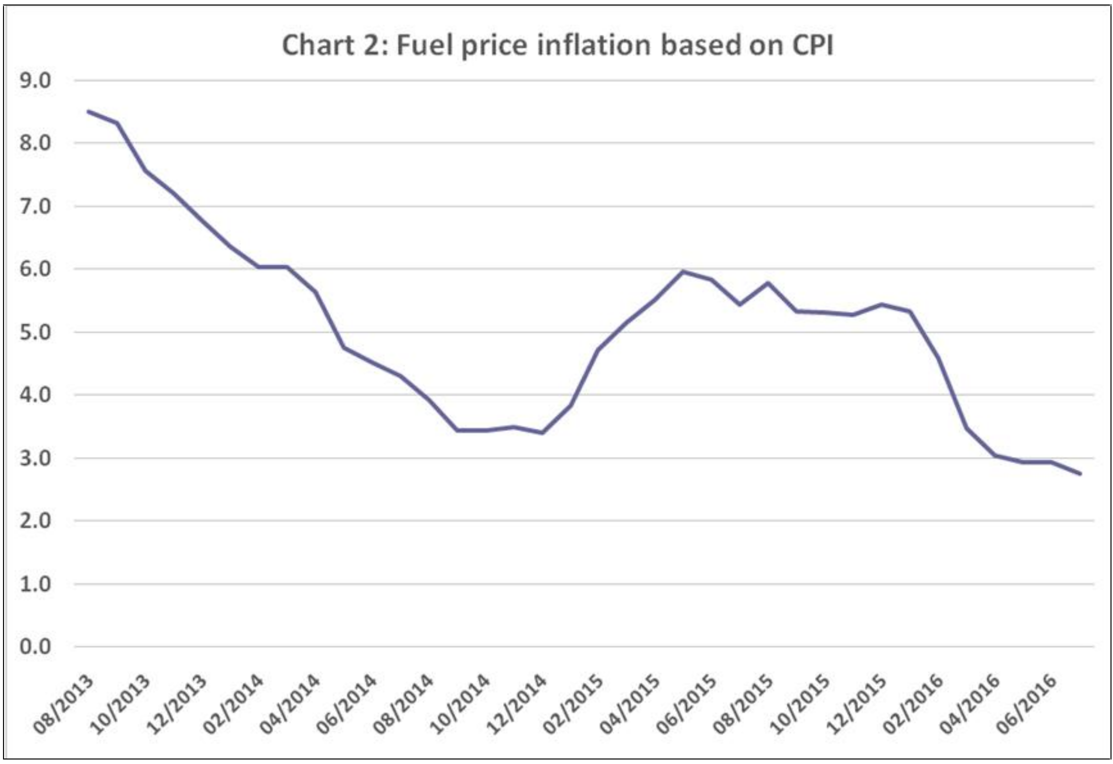
As Raghuram Rajan steps down as Reserve Bank of India Governor, news comes in that inflation as measured by the Consumer Price Index (the RBI's preferred indicator) is rising and stands in July 2016 above the 6 per cent ceiling for the institution's targeted range. As Chart 1 shows, the year-on-year rate of inflation began rising in August 2015, and despite a dip in the first three months of 2016 was at its highest in July 2016 over the year ending that month.

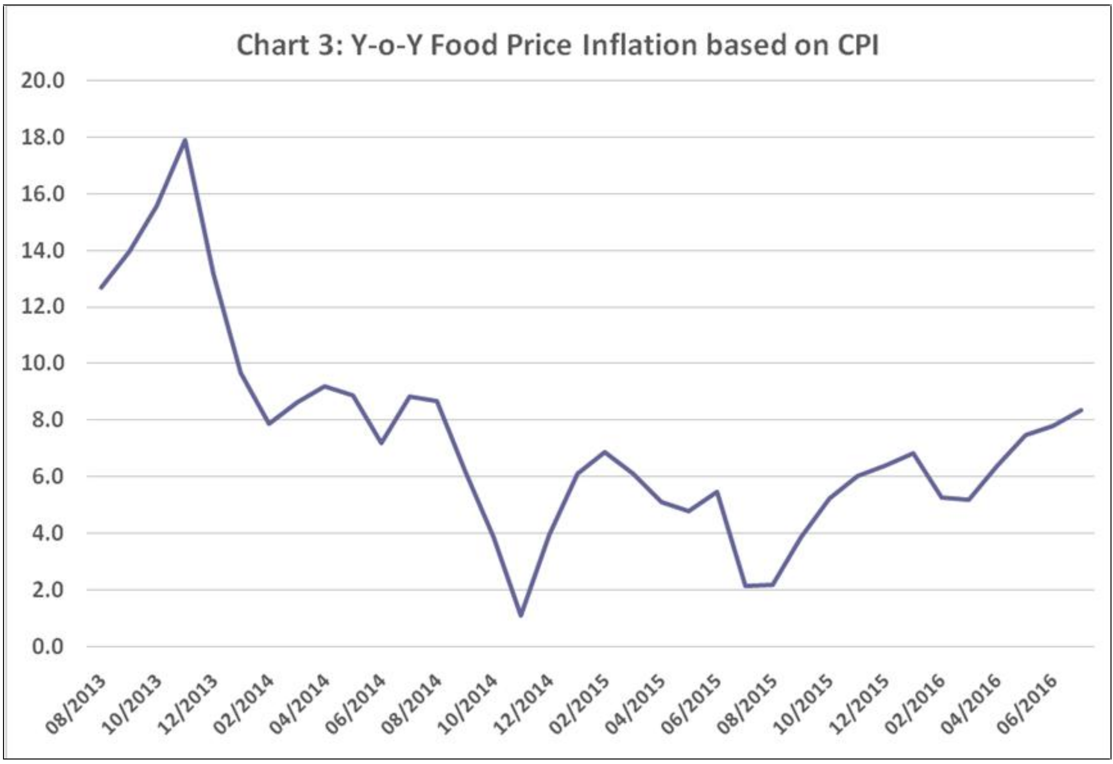


One reason for this could be the reversal of the decline in the international price of oil, that affected the average price of India's basket of crude oil imports. The weighted price of that basket had fallen from $109.05 a barrel in June 2014 to $28.08 a barrel in December 2015. But it has since risen to $46.96 a barrel in June 2016 and settled slightly lower at $43.52 in July, before rising again to $46.58 as on August 25 (or 66 per cent higher than its average December price). However, this can at best explain only a small part of the overall consumer price inflation rate, since "Fuel and Light" carry a weight of only 6.84 in the consumer price index. In fact, the rate of inflation of fuel prices in the combined CPI is at a low of 2.7 per cent in July 2016 (Chart 2). This is, therefore, no explanation.

A more important contributor to the rise in the inflation rate seems to be the rise in the food price component in the index. The year-on-year monthly rate of inflation in the prices of food items that account for a weight of 39.06 per cent rose from 2.2 per cent to 8.4 per cent over the year ending July 2016. This acceleration in the rate, though influenced by the “base effect” of lower than normal price inflation in the previous year, is surprising for a number of reasons. To start with, it occurs at a time when the prediction (supported by initial rainfall figures) is that the south-west monsoon starting June 2016 is likely to be normal or in excess of normal. Secondly, it accompanies a slowdown in the rate of industrial growth and some relative sluggishness even in the GDP growth rate as measured by the new national income statistics with 2012 as base. Industrial growth as measured by the IIP stood at 0.6 per cent over the April to June 2016 period, as compared to 3.3 per cent during the same period of the previous year. Finally, the inflation rate has risen above the RBI’s target range despite the fact that the Reserve Bank of India has been cautious in its reference rate reductions in response to the earlier deceleration in the inflation rate. The repo rate stands at 6.5 per cent as compared with the high of 8 per cent it had been raised to and kept at over the year beginning January 2014. It had stood at 7.25 per cent when Rajan took over as Governor in September 2013.



Given the fact that one complaint against the outgoing RBI Governor was that he was being overcautious on inflation and keeping interest rates at unwarranted highs and adversely affecting growth, the current rise in inflation is sending out a message. Either the repo rate is not an effective instrument for reining in inflation, or something has transpired in recent months that is rendering that instrument ineffective. Rajan has dismissed the July rate saying that it is a temporary phenomenon. “We finally have a framework that commits us to low and stable inflation. Yes, July’s inflation reading was a high 6.07 per cent, but I have no doubt that inflation will fall in the months ahead,” he reportedly said in a speech to the Foreign Exchange Dealers Association of India (FEDAI). The difficulty with that position is that it misses the fact that the recent phenomenon, even if “temporary”, goes completely contrary to expectations since it occurs when everyone is predicting that a good monsoon would raise food production, bring down food prices and moderate inflation.



According to the Indian Meteorological Department, Cumulative Rainfall over the period 1 June to 24 August 2016 was just 2 per cent below normal over the country as a whole. It was in excess of the long period average or equal to it (normal) in 26 out of 36 meteorological divisions. Based on monsoon predictions, the government has set a target of 270.1 million tonnes of foodgrain production in 2016-17, well above the target of 264.1 million tonnes that had been set for 2015-16 and the current estimate of 252.2 million tonnes for foodgrain production in 2015-16. Combined with the fact that the stocks of foodgrains with the government was 49 million tonnes (22.1 million tonnes of rice and 26.9 million tonnes of wheat) on 1 August 2016, as compared with 55.4 million tonnes (18.7 million tonnes of rice and 36.8 million tonnes of wheat) on 1 August 2015, this should have resulted in a moderation of food price inflation.

Normally, this would be suggestive of either a cost driven price increase or a speculation driven increase. One reason why speculation may be playing a role is that the north western region of India has experienced deficient rainfall. As on 24 August 2016, rainfall was deficient to the tune of 24 per cent in Haryana and 25 per cent in Punjab. This could have triggered some speculative holding, which together with price increases in inputs, could explain the rise. If that is the case, Rajan’s prediction may remain unrealised. It would also mean that the central bank’s attempt at inflation targeting is not working. Nor would the elevation of Urijit Patel, described by the BBC as an “inflation hawk” who would keep interest rates high if necessary, help to address the problem. Unfortunately, inflation would only strengthen the fiscal conservatism of the government with even more adverse consequences for growth.

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