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Inflationary Pressures in the Indian Economy

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The recent policy statement of the Reserve Bank of India (RBI) signifies a departure from the stance that it had been adopting in the last three quarters. There are three elements that are different. First, in leaving key policy rates unchanged, it has acknowledged that liquidity is not an obstacle to growth at present, but banks are showing a reluctance to lend. Second, by acknowledging that the growth of money supply at 20 percent is high and needs to be brought down,[2] the RBI is concerned about money growth. Third, in cautioning about inflationary pressures, the RBI is setting its sights on tightening monetary policy in the near term. All these have significant implications for the Indian economy.

The estimates for growth have been increased to 6.5 percent and, even in spite of the monsoon shortfall, the RBI expects that growth will pick up. In the first quarter of the year, most of the manufacturing companies produced good results and the cement, petrochemicals and fast-moving consumer goods sectors have reaped healthy profits. This is in part due to the fact that input costs have come down as commodity prices internationally are ruling at levels far below the peaks of 2007. At the same time, the RBI is not able to pitch for a higher growth rate, for it sees India as a supply-constrained economy and does not see adequate growth in investment portfolios to ease these constraints.

The consequence of these numbers is that if growth is around 6.5 to 7 percent, and money growth is close to 20 percent, the RBI appears to be worrying about inflation. While the RBI's rhetoric can be interpreted in many ways, its higher inflation, output and money growth forecast can be argued to represent a relatively clearer and more objective signal of its concerns over inflationary pressures ahead. The RBI lifted its inflation forecast for end-March 2010 to five percent (year-on-year) from four percent and now sees an upside bias to its FY2009 (ends March 2010) growth forecast of six percent (its forecast was 'around' six percent earlier). It also judges that the risks to its inflation forecast lie on the upside. It also lifted the indicative targets for broad money to 18 percent from 17 percent, a direct consequence of greater debt monetisation. First, we note that the RBI's inflation forecast implies a sequential rate of rise in prices of approximately five percent (MoM, Saar) from July 2009 to March 2010. In other words, inflation would already be higher than the 'range of

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[2] The RBI's Governor, Dr D. Subbarao, said in press interview on 28 July 2009 that 18 percent is a projection and not a target.

4.0-4.5 percent' that the RBI wants to 'condition perceptions' to. The statement reflects a shift in the RBI's stance from supporting growth to closely watching inflation.

In any case, the RBI's task of simultaneously managing the government's borrowing programme and inflation may be increasingly challenging in the months ahead. Going by new inflation projections (released last week), sequential wholesale price index inflation should average five percent (MoM, Saar) from August 2009 to March 2010 and inflation should cross the RBI's comfort level of five percent (year-on-year) by February 2010 and reach six percent (year-on-year) by March 2010. This is also higher than the RBI's new forecast of inflation hitting five percent (year-on-year) by March 2010. This may force the RBI to raise rates as early as October 2009 and take other steps to withdraw liquidity.

Second, if we understand the forecasts with the help of the Quantity Theory of Money equation, gross domestic product (GDP) growth of six percent and broad money growth of 18 percent point to inflation much higher than five percent. The equation spells that money has to be either chasing goods (that is, facilitating a higher transaction volume of output) or chasing prices higher. If money growth exceeds GDP growth by this margin, it is itself likely to be inflationary. Third, an interesting feature of the revised forecasts is that the RBI is forecasting inflation rising to five percent even as it sees growth staying below the seven to eight percent widely seen as potential growth. It is also concerned about inflation rising in the months ahead 'even without any major supply shock'. Rather, the RBI has attributed India's constrained growth to supply side factors in the statement, 'Notwithstanding the temporary hiccups of the crisis period, India is not a demand-constrained economy; it is a supply-constrained economy'.

Finally, if risks of inflation lie to the upside of five percent as the RBI noted, it does suggest that the balance of risks has shifted towards controlling inflation. Inflation at five percent is not low, and upside risks to five percent inflation naturally tilts the balance of risks towards inflation. It is important to note that monetary policy cannot sustainably lift growth towards the seven percent forecast of the government. Therefore, the RBI's (still low) growth forecast matters less than its (rising) inflation forecast. The rhetoric also clearly reveals the RBI's discomfort towards inflation. For example, the RBI noted that its immediate challenge is to 'balance between the short-term *compulsions* of providing ample liquidity and the potential build-up of inflationary pressures'.

The other evidence of the shift in stance came in the macroeconomic review released a day ahead of the policy meeting. In the report, the RBI implicitly laid out conditions it believes are necessary for inflation to remain moderate – conditions that are not actually fulfilled and unlikely to be easily fulfilled. It said, 'Inflationary pressures may remain moderate if the protracted global recession leads to dampened commodity prices, agricultural growth remains unaffected despite the delayed progress of monsoon, and the accommodative monetary policy stance returns to normal levels.' This is just another way of revealing that it expects inflation to rise if it does not hike interest rates. That said, it remains to be seen if the government's borrowing programme (and the debt monetisation) makes it difficult for the RBI to hike interest rates and raise the cash reserve ratio early. There may be resistance to hiked interest rates until it is obvious that inflation is rising fast, as growth is far from the nine percent rate that the government desires and the seven percent rate that it is targeting.

Moreover, the RBI is still supposed to buy back around Rs 460 billion of government debt before September 2009, funding almost half of the remaining amount that the central government borrowed in the first half (April-September) of the fiscal year. This would lead to a further increase in liquidity – contrary to attempts of reducing monetary accommodation a couple of months later. Hence, it may be increasingly challenging for the RBI to simultaneously manage inflation and the government's borrowing programme.

In India's case, the dual mandate of the RBI to support growth and control inflation, and the lack of clarity on whether output is running above or below potential at any point, has meant that the RBI tends to move rates only after it sees inflation rising. This is what happened in 2008, and will probably happen later in 2009 or early 2010. Going by projections (released last week), inflation should cross the RBI's comfort level of five percent (year-on-year) by February 2010 and reach six percent (year-on-year) by March 2010.

There is another factor that is likely to exacerbate inflationary pressures. Additional allocations for the National Rural Employment Guarantee programme this year are substantially higher compared to last year. Several good monitoring systems have been put in place to ensure that leakages are reduced. There is secondary evidence that the money is reaching those who need it – there is an outcry in the media that the programme is artificially increasing wage rates and thus putting a pressure on manufacturing costs. More importantly, more money in the hands of the poor means that, in instances where they were having one meal a day, they would now be able to have two or at least a meal and a half a day. However, the programme does not focus on agriculture or food production and, hence, there is little or no impact of the programme on agricultural output. This has had an effect on food prices. While there are adequate stocks of rice and wheat in the public distribution system as well as in the open market, there is pressure on other food articles, most importantly, pulses (these are an important ingredient in the Indian food basket), meat, sugar and vegetables. The consumer price index increases hover around 10 percent on a year-to-year basis and there is likely to be greater pressure on the food articles component of this index. The poor monsoon is also likely to exacerbate this impact. The next few months will see a sharp increase in the prices of food articles. Coupled with the inflationary pressures mentioned previously, it is likely that there may be a fresh bout of high inflation, forcing the government to rein in monetary expansion. This is likely to constrain expectation of growth in the coming year.

Finally, the buoyancy in the financial markets appears to be due to the good first quarter results of corporates just published, coupled with the considerable liquidity available in the economy. The Asian stock markets have recovered to some extent and there is a flow of funds into the Indian markets. However, it is unlikely that this buoyancy will be sustained if there is a threat of high inflation and monetary contraction leading to contraction in growth.

The next few months appear to be quite crucial for the Indian economy.

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