

Developing Trends

Oxus Research Report

Indian Inflation: Populism, Politics and Procurement Prices

Aggregate demand is not even close to being as strong as the RBI claims – in fact, demand is weak, and weakening.

India's excess inflation is mostly due to the high populist minimum support prices for agriculture.

Inflation has peaked, and yes, so has the RBI's repo rate.

PS: No justification for recent RBI rate hikes.

Next Issue: Examining Central Bank Behaviour in the G-20 Economies; scheduled for 9th September, one week before the RBI Mid-Quarter Monetary Policy Review.

Surjit S. Bhalla | surjit.bhalla@oxusinvestments.com

Ankur Choudhary | ankurc@oxusinvestments.com

Nikhil Mohan | nikhil@oxusinvestments.com



Introduction

India's central bank, the Reserve Bank of India, increased its repo rate by 125 basis points from 6.75 percent to 8 percent in the space of just 3 months. This is the second fastest increase on record, nearly matching the gallop from 8 to 9 percent in June-July 2008. In 2008, the fast gallop led to a sharp reversal, aided only in part with the onset of the Global Recession. All indicators are that the present 8 percent repo level will mark a peak.

This extreme action has been undertaken by the central bank because of persistently high inflation. This anomalous inflation, it is believed, has persisted for the last year and a half, and has proven wrong the expectations of all the policymakers and most of the economists. The reasons behind this price rise, the examination of the central bank's actions, and pointers for the future are the main focus of this Research Report, the second in our quarterly *Developing Trends* initiative.

The first issue, dated March 2011, titled "*Everything you wanted to know about inflation (and more)*" made, in the main, the following five points. First, that the Indian central bank was unique, and wrong, in using the wholesale price index as its *primary* indicator of inflation. Second, that the main drivers of inflation in the world had moved from demand pull to cost-push; and that cost-push occurred mainly through oil prices. The speculative oil price led the way for other commodities, including food, to cause a ripple effect throughout the economy.

Third, that emerging economies like India were more susceptible to this influence than developed economies. Fourth, that monetary policy in the form of raising interest rates was not the desired response when faced with commodity inflation. Fifth, that not just now but for the last thirty years, the traditional assumed drivers of inflation, money supply growth and fiscal deficits, had literally no role to play in India's inflation. Fifth, and finally, the Report ended with a forecast that the appropriate indicator of inflation, the consumer price index, had peaked in late 2009 and would decline to the "5 percent range" in the next six months.

We stand by our forecast – especially on the decline though we might miss the level by a month or so. Based on the analysis contained in this report, we make a new forecast – the RBI *should be done* with raising rates. This is contrary to the forecast made by the RBI itself, several expert analysts, and India's Finance Minister, Mr. Pranab Mukherjee. Of course we could be wrong – but the reason we are going out on a limb is because of the evidence about inflation, and GDP growth, presented below.

The three key findings of this report are as follows –

- First, regardless of the indicator used to assess economic growth, the economy has slowed down – considerably. Investment grew at a zero percent year on year rate during Jan-March 2011. Average industrial growth (seasonally adjusted) is down to a zero percent rate during Jan-May 2011. That is only a slight exaggeration since the estimated number is 0.5 percent, SAAR.
- The second and equally important finding in this report is the establishment of a strong link between the minimum support prices (MSP), also called procurement prices, and food inflation in India. We present evidence via the construction of an MSP index covering the 16 odd crop prices that come under the MSP system. The link between the index and inflation suggests that a 1 percent increase in MSP prices leads to a 0.3 percent rise in the consumer price index.
- Third, Indian policy making is characterized by a high degree of either extrapolation or "rear window" economics. Whatever worked in the distant past, will continue to work. Or whatever has happened in the past, will continue to happen. This is illustrated by the government's forecast of both growth and inflation. Growth will continue to be above 8 percent, and inflation will continue to be close to double digits. A study of the determinants of each, as provided in this report, suggests that the official forecasts are going to be doubly wrong. GDP growth may not exceed 7 percent, and inflation could fall much further than the government is planning for.

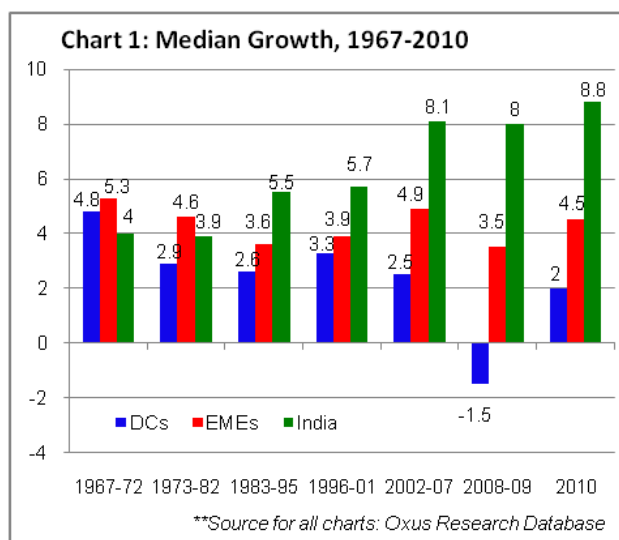
All of this suggests that the RBI *should* decide to hold rates steady at its next meeting in September. The consensus is for another 25 basis point increase.

Trends in growth & inflation

A perspective on where world growth has been, and whether inflation has followed, is provided by the two charts below. The “world” in this Research Report consists of the G20 economies (actually G-19 since the European Monetary Union is not a country) plus the economies of Chile, Hong Kong, Israel, Malaysia, Philippines, Singapore, Taiwan and Thailand. These 27 countries are then divided into their developed and emerging market components. Three of these economies were outliers at some point or another during the last 20 years (Argentina, Brazil, Turkey), and subject to their outlier status, they are omitted from the analysis and pattern of means. Countries have been divided into developed countries (DCs), and emerging market economies (EMEs). The periods chosen correspond to major “episodes” in world growth, and the statistic of choice is the median rather than the mean (to prevent outliers from messing up the data – the picture remains the same with both the mean and the median).

Growth

DC economies: They have seen a steady fall in their GDP growth from about 5 percent in the late sixties to near 2.5 percent until the Great Recession of 2008. How long the developed countries take to return to 2.5 percent growth is a subject of much debate, if not speculation. But it is important to note that 2.5 percent growth was the “norm” during the go-go growth years preceding the recession.



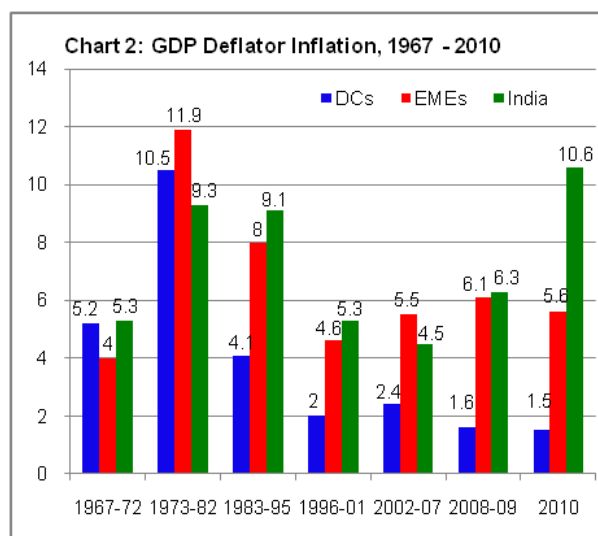
EMEs: If you had to pick a number for the median growth over the last near 50 years, it would be 4.5 - 5 percent. The Latin American debt crisis, and its aftermath, brings down the median growth to slightly less than 4 percent during the 1980s and 1990s. And since the dawn of the new century, EME growth is back to near 5 percent.

India: That India started to break out from the pack in the 1980s is clearly brought out by the data on GDP growth. From near 4 percent, Indian growth accelerated to the 5.5 range for the twenty odd years, 1980-2001. The growth gap with other emerging economies during this period: approximately 2 percentage points higher for India. From 2002 onwards, India has grown steadily at 8 percent plus, and the growth gap has doubled to about 4 percentage points.

Inflation

The story of GDP deflator inflation in the DC economies is one of gradual decline (excepting the oil price decade 1973-1982) to around 2.5 percent per year during 2002-2007. Somewhat surprisingly, aggregate GDP deflator inflation has declined in the Western world by almost a full percentage point to 1.5 percent in the commodity boom period 2008-2010.

For those who argue that commodity prices, or money supply growth, or liquidity surplus, causes the aggregate inflation to rise in developed economies – well, these numbers do not vindicate any of these monetary hypotheses.



EME inflation follows a similar path to DC inflation. After ranging around the double digit level for some 20 years after the first oil price hike of 1973, EME inflation declined somewhat precipitously to only 5 percent for the period 1996 to 2007. Post the Great Recession and despite food and oil prices ranging at record levels, EME inflation is less than one percentage point higher than the halcyon period 1996 to 2007.

India follows a near identical path to other emerging economies until 2009. But something seems to have gone awfully wrong since then. Indian inflation jumped to 10.6 percent from an average of 6.3 percent during the preceding two years. It is this fact that has perhaps propelled the RBI to take *extreme* action. But appearances can be deceiving – which appearance, and which deception, is the subject matter for *extreme* analysis.

Indian Inflation higher since 2007 – Different and Why

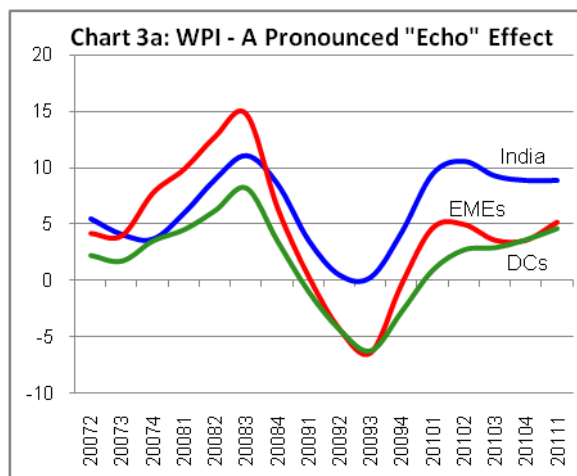
The pattern of Indian and world inflation for three different inflation indicators are plotted below.

The first important stylized fact is of a pronounced “echo” effect in world inflation. Note how regardless of the indicator (with the important exception of the Indian CPI – see below) there is a jump-up in inflation in 2008 (commodity price boom), an overkill decline (echo) in such prices in 2009, and a jump back (echo) to near normal price pattern in 2010. The echo effects are only present in exceptional years and according to all hypotheses, 2008 to 2010 were exceptional years. The current year (2011) should be one of return to normality.

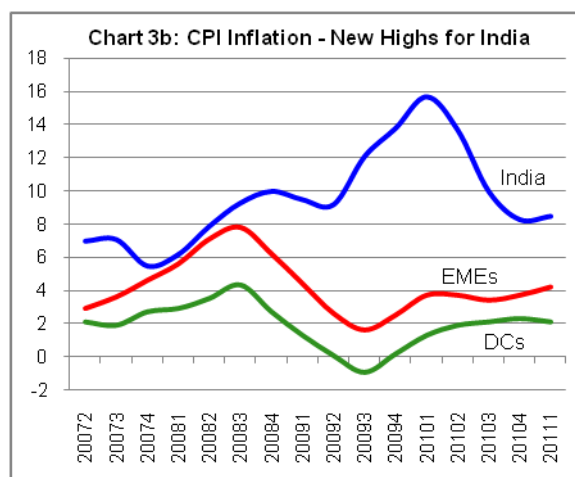
The second important stylized fact is that all three indicators point to Indian inflation significantly departing from EM trend in the last few years.

PPI: Indian producer (wholesale) prices (the RBI’s most favoured indicator of inflation, and *not* of any other central bank in the world) suggest that something went wrong starting the third quarter of 2008. After being be-

low or equal to EMEs, India’s WPI inflation started registering a large average gap of 5 percentage points. At the depth of the price fall in 2009:3, EME prices registered a -6 percent year on year inflation; India only zero percent. Since then, EME producer prices have bounced back to their pre-recession average of 5 percent; while India has “settled” to a higher 9 percent level.

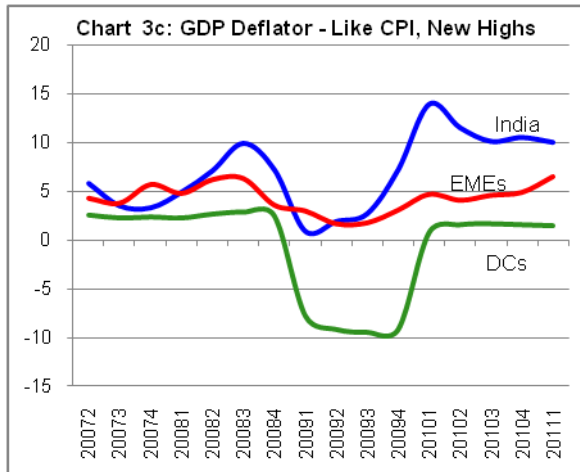


CPI: Examination of the more accurate reflector of inflation, consumer prices, suggests that the divergence in EME and Indian inflation started about the same time as the PPI – the Lehman third quarter of 2008. While world indices slumped in 2009, Indian CPI went merrily upwards peaking at 16 percent in the first quarter of 2010.



GDP deflator: The highest peak for GDP deflator for the world was during 2008. For India, the 2010 peak exceeded this level by 6 percentage points. Since 2010:1

Indian inflation shows a clear decline while inflation in EMEs and DCs has flattened out. Going forward, this decline in Indian inflation is likely to persist.



While the inflation series generally move together, for one year, 2009, there is a huge divergence between the Indian CPI and Indian GDP deflator. This cannot be explained away easily; perhaps over the coming years, GDP deflator indices for 2009 will be revised upwards. For 2009 the WPI and deflator mimic each other, when in general the correspondence should be between the CPI and the GDP deflator. Note that the WPI captures only 22 percent of the Indian economy, the CPI over 70 percent (i.e. the CPI is considerably more representative of economy price trends while the WPI/PPI has only limited applicability – but don't tell the RBI that!). As the previous research report had documented (*Everything ...*), GDP deflator inflation in most of the world, and in India, is explained by CPI inflation, and not WPI inflation.

The conclusion is straightforward. Exceptionally, Indian inflation has not followed the world trend for the last three years. Indeed, Indian consumer price inflation has yet to see the “low” levels witnessed before July 2008! In 2008:2, year on year CPI inflation was 7.9 percent. With domestic tightening, global recession, global recovery, and Greece debt crisis – you name it; Indian consumer prices have yet to climb at a lower rate. However, this is about to change.

The Official Explanations for Inflation

Inflation determination can conveniently be summarized into two lumpy categories – demand pull and cost-push. The former can lead to inflation when growth is too “high” i.e. the economy is overheating; the latter can occur when the prices of items in inelastic demand e.g. food and energy, rise because of “supply” bottlenecks. Both effects are analyzed in some detail below.

The authorities and experts are not clear about the causes for the Indian inflation problem. Neither demand-pull, nor cost-push, or any matching thereof, can explain the problem. Not surprisingly, this has led to some hand-wringing and speculation, in official circles. The Big Question; *what happened?*

In the main, there are at least six popular, political, and puffy explanations for the high inflation in India in recent years and especially in 2011. These explanations originate from either the Ministry of Finance (MoF) or the Reserve Bank of India (RBI). All of them are found wanting in one way or another, as shown.

1. MoF: The whole world is experiencing inflation and Indian voters and analysts should “credit” the government with doing a good job in a bad situation.

But then why is India inflating a lot more?

2. MoF: Developing countries have higher inflation than developed countries.

But developing countries show only a 1 percentage point increase over their 1996-2007 base, while India shows a 5 percentage point increase. Why so?

3. MoF and RBI: Indians are less poor now and have started to eat more protein. So food inflation, and overall inflation, is higher.

Food is about 50 percent of the CPI, and agriculture is less than 20 percent of GDP. You can work out the math about the protein component – the less said about this desperate explanation, the better.

4. MoF: There is an output-inflation tradeoff and Indian GDP growth has accelerated to 8 percent plus and therefore inflation is higher.

But it did precisely the opposite for India during 1996-2007 compared to 1980-1996, and precisely the opposite for the emerging market economies for the last thirty years.

5. RBI: Inflation is high because inflation expectations are high. If inflation expectations are brought down, inflation will come down.

This is just confusing an “identity” with causality.

6. RBI: Core inflation is high. Non-food manufacturing WPI inflation is not slowing down because manufacturers have too much pricing power. This ability to still exercise pricing power is what is keeping inflation high.

Potentially, a legitimate concern, except the RBI seems to have read the data upside down. This is discussed in more detail later.

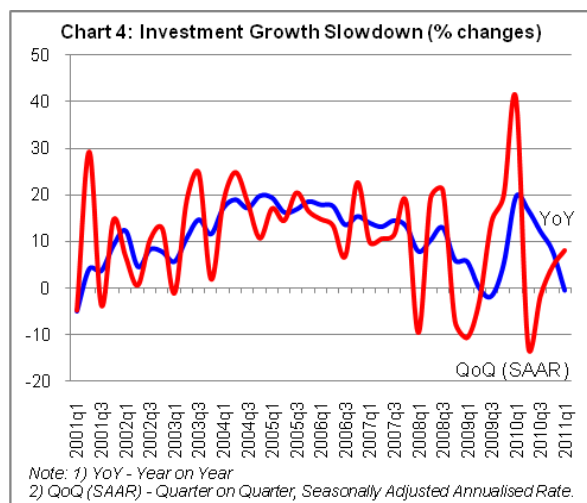
RBI: Demand pressures remain strong...No!

The RBI still believes that demand-pull inflation is an important part of the story - “Demand pressures have remained strong”. Conversely, the RBI hedges itself by stating that “...growth is beginning to moderate...however, there is no evidence as yet, of a sharp or broad-based slowdown”. Does this mean that the RBI *wants* a sharp slowdown in order to win its battle against inflation?!

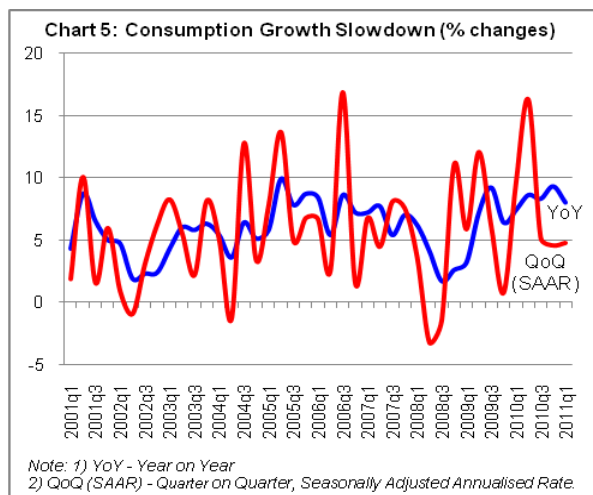
The trends in three indicators of demand are examined below – investment, consumption, and industrial production. Each graph plots both the year on year growth rate (y-o-y) as well as the SAAR (seasonally adjusted annualized rate, Census X-12 method), The latter is to be preferred since that has the relevant information for policy. But both are presented, and commented upon, since that is official policy. The starting period may be different, but only because the graphical representation does not get affected by outliers prior to 2001.

Investment: This GDP based series is volatile but the y-o-y rate has declined to less than a zero percent rate

March 2010-March 2011! There are only two other instances of negative growth in this series since the availability of quarterly records in 1996:2 – minus 5 percent in the first quarter of 2001, and minus 1.7 percent in the third quarter of 2009.

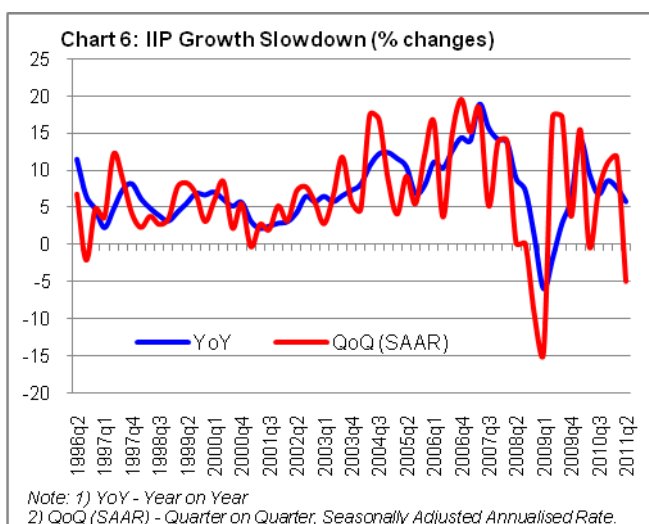


Consumption: Growth in private final consumption expenditures (SAAR) has declined to a less than 5 percent rate, the lowest since 2005 if one excludes the 2008 recession quarters in 2008. This decline is observed in the high growth quarter of Jan-March 2011. For the last three quarters (June 2010 – March 2011), consumption growth has averaged less than 5 percent. Since India’s growth acceleration began in 2003/4, and excluding 2008, both the mean and the median for consumption growth are close to 7 percent. To reiterate, the last quarter for which the RBI had GDP data (Jan-March 2011), the evidence is overwhelming that consumption growth was not strong – indeed, was quite weak.

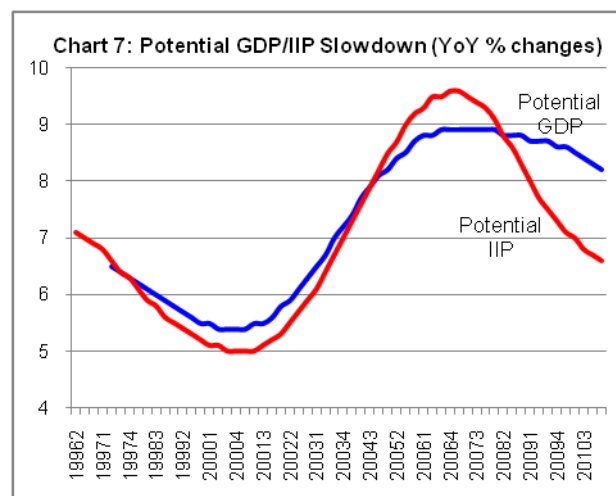


Industrial production: If the RBI is not convinced with the above data about growth being weak, it will likely not be moved by the data on industrial production (new series). The IIP y-o-y rate registers a big decline from its peak rate of 13 percent a year or so ago. May 2011 growth rate of 5.6 percent (y-o-y) is the smallest gain in the last seven years – again, after excluding the recession year of 2008. The SAAR 3 month growth is now negative (- 5 percent) and barring the 2008/9 recession years, is the lowest since 1993/94. The six month SAAR (not shown) rate is somewhat better at 3.4 percent but only because of the exceptionally strong first quarter of calendar year 2011. But that quarter belonged to the previous fiscal year.

Chart 6 underscores the folly of using year-on-year growth rates instead of the SAAR rates. And it leads to folly in assessment, forecast, and policy.



The final piece of evidence on the declining real economy is provided by calculations of the potential GDP and potential industrial growth. The potential or trend levels have been estimated using an econometric filter (Hodrick-Prescott). Chart 7 unambiguously shows that the decline in output growth has set in for quite some time now. Potential trend industrial growth is down to a 6.6 level, the same level observed in the first year of growth acceleration in 2003/4. Trend GDP growth has declined to 8.2 percent, a level not seen since 2004. Perhaps the government is looking at potential GDP while making its forecasts of actual GDP.



Regardless of the output series of choice, the fact is that the data are less than underwhelming about the conclusion of overheating, “strong growth”, demand-pull pressures on inflation, etc. The latest PMI data shows that in July 2011, at 53.6, the PMI index registers the fifth lowest monthly level since the series began in April of 2005 and excluding the recession/recovery years of 2008 and 2009.

Three premier policy “institutions” in India – the Ministry of Finance, the RBI and the Prime Minister’s Economic Advisory Council - all merrily believe that growth is strong and interest rates need to be hiked further. No demand related year-on-year data suggests that – and the SAAR data are loudly shouting that the situation is far worse. The fact that the RBI confidently predicts a GDP growth of 8 percent for this fiscal year suggests that the RBI is looking at data different than that made available to the public. It is impossible to derive the conclusion that “growth remains strong” from the different output series presented above and that it will still stick to an 8 percent GDP growth target. It might happen, but it will not be due to the official “explanations” emerging from the RBI or their colleagues in the Ministry of Finance.

RBI’s growth forecast is misguided – what about its inflation forecast?

The RBI has dual concerns – output and inflation. There appears to be little question that the RBI, and the government, are way off base when looking at output

growth. The government's and RBI's inflation assessment is examined next.

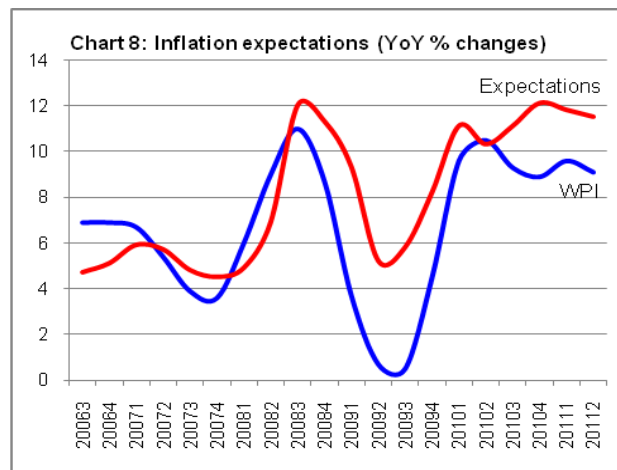
Inflation – Great Expectations?

Both verbally and in documents, the RBI seems to have blindly placed a lot of faith in its own measure of “inflation expectations”. The phrase “anchoring inflation expectations” has become the first commandment in the RBI's aggressive (yet directionless) fight against inflation. It believes that its survey of urban households provides “useful *directional* information on near-term inflationary pressures and also supplements other economic indicators to get a better indication of future inflation”. (*RBI Bulletin, June 2011, Inflation Expectation Survey of Households: March 2011, emphasis added*).

The RBI cites the survey results to buttress its belief that inflation is high in part because expectations are high, and that this justifies its sensational 100 basis point hike in repo rates to a recession-inducing level of 8 percent. Others', especially those with the belief that the RBI was/is behind the curve, are also resorting for justification from this inflation survey. If the survey has received so much prominence from experts, it is worth analyzing its behaviour and relationship with actual inflation.

Before examining the data – two broad comments. First, that the survey is for *urban* households and expectations are for the wholesale price index. Households never see this wholesale price and urban households are less than a third of the total population. Second, the expectations survey, as is all else practiced at the RBI, deals with year-on-year changes. The relevance of the y-o-y practice to the inflation expectations survey is that at the time of the survey what is being asked for is the annual rate of inflation one-quarter ahead. Chart 8 shows the inflation “expectations” and actual year on year inflation, for the quarter in which the survey was undertaken.

Note, one, the close correspondence between expectations of inflation for the future and actual inflation. Two, that the respondent always seems to over-estimate future inflation.



The respondent already knows the WPI inflation for almost three-fourths of the year, so “expected” future inflation might indeed be just a regurgitation of inflation that has *already* happened.

So what use is the survey and how is it adding information? Note that for 2011, while inflation has stayed steady and declined, the expectations have gone in reverse gear. If history is any guide, expect expectations of inflation to also decline in the coming months. Be warned: the survey of inflation expectations is injurious to forecasting.

What You have been waiting for - The Real Story of Inflation

We offer an explanation to the Indian inflation puzzle, and document its importance. Simply put, the occurrence of higher than expected inflation in India is not because of the fiscal deficit, money supply growth, commodity prices, or international inflation. But it is because of the populist, Machiavellian *re-election* vote-bank policies of the Congress, a party in power for the last seven years.

Procurement prices and Indian Elections

Procurement prices for agriculture set in motion a chain reaction which affects all other prices in the economy. The price of food goes up, which sets an increase in wages, which results in costs going up, which means output prices go up, which means an increase in the CPI (and WPI).

In most economies, domestic production and demand do not affect food prices much because of the policy of imports and exports. But not so in India, where the government is continuously interfering with the stabilizing influence of trade.

The political economy model of Indian inflation we offer is as follows. India is pre-dominantly rural and vote-bank politics would suggest that political parties facing re-election will jack up agricultural prices a year before the re-election. After the election, the relative price of food is brought down to its long-term equilibrium.

Testing of this model requires an index of agricultural prices set not by the market but by the government – as in India. India started its food policy (setting minimum support prices (MSP) or procurement prices, collecting output at such prices, and distributing food-grains through its “fair price” shops) in the mid-1970s. Such prices are available for a variety of crops e.g. cereals, sugar, cotton, groundnuts, pulses etc. Combining production and procurement price data, Oxus has developed a proprietary index of procurement prices – essentially, a value weighted index of the level, and percent change in the average MSP set by the government.

The effect of procurement prices on inflation is tested in a two stage process. The increase in MSP in any given year is a function of the inflation (CPI) in the previous year. In addition, there is an election year variable which is “on” in the year of the election and the year prior to the election. This gives time to the government to set in motion its re-election policy! Two elections are “dummied out” in the statistical analysis – the 1984 election which was the result of the assassination of Indira Gandhi and the 2004 election which is a real low outlier in terms of the increase in agricultural prices.

The model is run for the period 1978 to 2011 and the results are as follows (all coefficients statistically significant):

$$\text{MSP Inflation} = 2.3 + 0.53 \cdot \text{CPI}_{t-1} + 2.7 \cdot (\text{Election years})$$

Time-period 1978 to 2011; dummy variables for the following years 1983 1984 2003 2004 and 2008 (exceptional commodity inflation);

$$R^2 = .64$$

This equation yields the average inflation in procurement prices with zero lagged CPI inflation to be around 2.3 percent; each 1 percent rise in the previous year's CPI inflation sets in motion an extra increase of 0.53 percent in the MSP. And in each election episode, the government sets the MSP to be an average extra 2.7 percent higher.

How well does procurement price inflation explain consumer price inflation? Very well. For the period 1978 to 2006 (i.e. before the resurgence of CPI inflation in India), and with year dummies for outlier years 1983, 1991, and 1998, the variance explained is 56 percent.

$$\text{CPI inflation} = 5.1 + .30 \cdot (\% \text{ change in the average procurement price}).$$

This suggests that, for every 10 percent increase in the index, there is a 3 percentage point increase in CPI inflation. For zero increase in procurement prices in any given year, CPI inflation would be, *ceteris paribus*, 5.1 percent. During the out of sample period 2007 to now mid-2011, procurement prices have risen by 75 percent. (For the re-election years 2008 and 2009, procurement prices rose by 37 percent). On the basis of procurement prices alone, annual CPI inflation should have been higher by about 4.5 percentage points above the ‘base’ of 5.1% for each year during 2007 to 2011 – i.e. it should have averaged 9.6% annually. Actual CPI inflation for the same period was 9.5%! And this level of accuracy is without any RBI or money supply growth or fiscal deficits or overheating in the model - only procurement prices!

It is revealing that in the major re-election year of 2004 for Mr. Vajpayee's government, international food prices went up by 15.2 percent, the predicted MSP increase was 6 percent, yet the actual increase was only 2.4 percent, the third lowest increase on record. The two lower MSP increases were in 1975 (0.9 percent) and 2002 (1.3 percent).

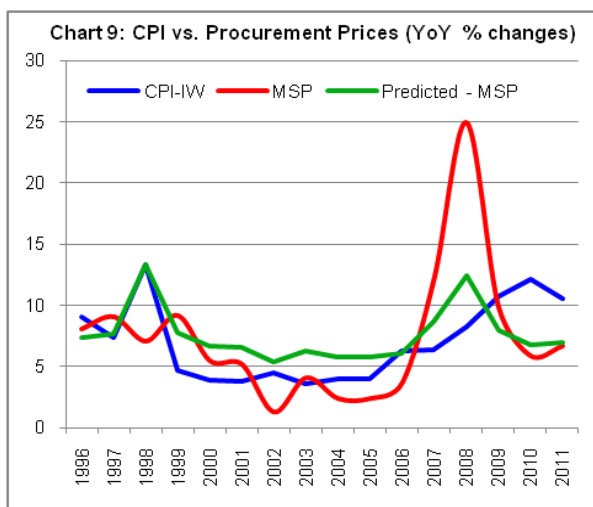


Chart 9 documents the trend in the causal variable, MSP inflation, predicted MSP inflation and CPI inflation. The outlier nature of the 2008 and 2009 MSP price increases is evident. It is not a coincidence that for the last five years, procurement prices rose at record rates of 12 percent per annum; consumer price inflation followed suit with a record rate of 9.6 percent.

Model Forecast for 2010 & Beyond: Procurement prices have risen by “only” 5.9 and 6.7 percent in the last two years. Consumer food prices rose at a 12.2 percent rate in 2010. In June 2011, these prices had inflated at an 8.6 percent rate. In late July, CPI food inflation was down to 7.3 percent. The MSP model predicts inflation in the 7 percent range for both 2010 and 2011.

Given that CPI inflation has averaged higher at 11 percent in the last two years, the forecast of 5 to 6 percent CPI inflation by the end of the year does not appear to be that outlandish.

Election motivated policy: some intended consequences

The damaging effects of election motivated food price policy is clearly brought out by the trend in relative prices, especially since the Congress’s resumption of power in 2004. Relative prices are important but generally should not result in long-term overall inflation levels to rise (or fall). *This “natural outcome” does not occur when the relative prices are set by the government.*

There have been some striking changes in relative prices that bear comment, and that may have been more than partly responsible for the high inflation that India has been witnessing.

Given the evidence of the procurement prices cycle, two relative prices, both related to agriculture (food) are computed. The two are the food to non-food components of the CPI and WPI.

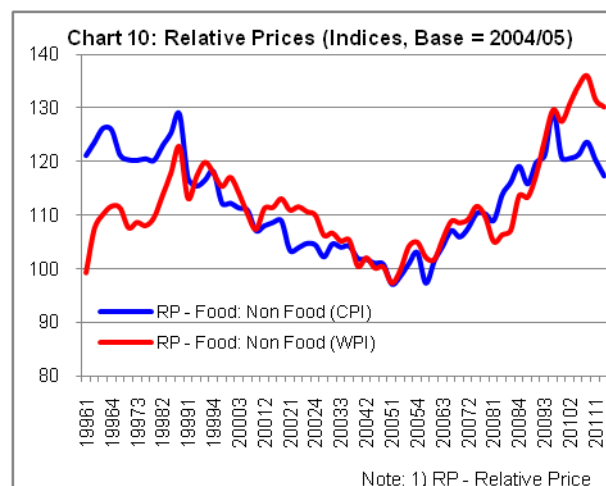


Chart 10 plots the trend in the two relative prices. The chart highlights the outlier status in the mid 1990s, and post 2007. Not coincidentally, these two time zones are also associated with high overall inflation. Note also the recent sharp decline in the relative price of food, whether measured in the WPI or CPI. This augurs well for lower inflation India, and fulfillment of our forecast!

What really constitutes RBI’s pricing power?

In recent months, the RBI has constantly been mentioning one price as a major contributor to India’s high inflation: the price increases set by manufacturers of non-food items. It calls it “pricing power”. According to the RBI, this pricing power is indicated not by an increase in relative prices, but by an increase in absolute prices! After its surprise 50 basis point hike in May 2011, the RBI said:

“Non-food manufactured inflation was 8.5 percent in March 2011. Provisional data indicate that it increased from 6.3 percent in April to 7.3 percent in May 2011, numbers much above its medium-term trend of 4.0 percent. This pattern in non-food manufactured products inflation is a matter of particular concern. Besides reflecting high commodity prices, it also suggests more generalised inflationary pressures; rising wages and costs of service inputs are apparently being passed on by producers along the entire supply chain”

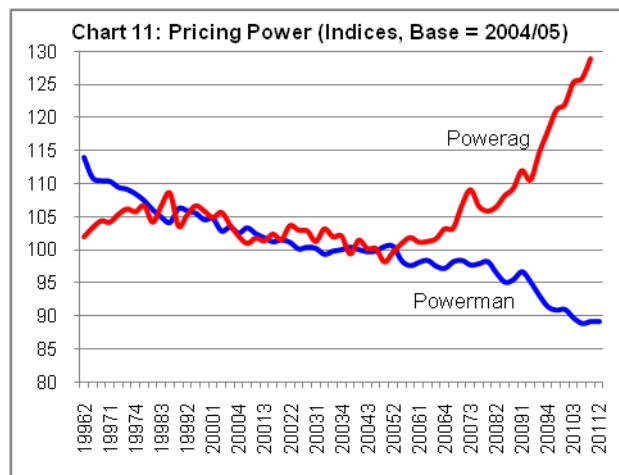
If input costs go up by 10 percent and output prices by 5 percent, the RBI would have us believe that there is pricing power on the part of the firm when in reality (assuming productivity and technological change to be zero) the firm is going out of business. But if input costs go up by 10 percent, and the firm’s output price goes up by 15 percent, then it has some pricing power. Pricing power generally means an increase in the price of output relative to the price of input.

Thus, the pattern of relative prices and not absolute prices is indicative of pricing power. A test of the RBI hypothesis underlines how off-base the RBI is in its assessment of who contributes what to India’s inflation. Chart 11 plots two relative prices – (i) the price of agricultural goods to non-agricultural goods (national accounts data and labeled Powerag); (ii) the price of manufactured non-food to the overall price index (WPI data, labeled Powerman);

Three very strong results emerge. First, that Powerag moved in a very narrow +/- 4 percent range during 1996-2004, the entire non-Congress period. The average level was 103.7 with fiscal year 2004/5 equal to 100. Second, that Powerman has shown a steady decline from 113.9 in 1996:2 to 100 in 2004:2. Some decline in Powerman is expected given higher productivity growth in manufacturing.

All the three series move in a narrow range between 1996 and 2004. And then something breaks loose. The pricing power of agriculture goes through the roof, and the RBI feared pricing power of manufacturers goes through the floor. The relative price of non-food manufactured goods is down by more than 35 percent since the Congress came to power, and more than two-thirds of this loss came in just two years: pre-election year 2008 and election year, 2009.

All these *relative* prices show only one pattern – a sharp movement upwards in the last four years, and this exponential path is highly correlated to the *absolute* price increases in the procurement prices, and Congress’ successful re-election bid in May 2005.



The simple conclusion is that regardless of how measured, *relative* prices of food have increased by over 30% since the UPA came to power in 2004. This is sufficient evidence to call the bluff on the government’s desperate attempts to make growth and international commodity inflation the fall guys for their deliberate and damaging brand of populism.

Some firm conclusions...

First, aggregate demand is not even close to being as strong as the RBI would have us believe. In fact, domestic demand growth (consumption, investment, IIP or PMI), whatever your fancy, has slowed down drastically over the last 5-6 quarters.

Second, there is a strong relationship between the politically determined minimum support prices (MSP) in agriculture and the overall level of inflation. For every 10% increase in procurement prices, CPI inflation rises by 3.0%. With the next general elections not till 2014, and growth slowing down, there is little likelihood of another round of unjustified increases in the MSP. As a result, CPI inflation is set to decline to less than 6 percent in the next few months, and the RBI’s repo rate should follow with a lag.

Disclaimer

The views expressed are as of End July — Early August 2011 and are a general guide to the views of Oxus Research & Advisory Services Private Limited. Commentary is at a macro policy or strategy level.

This document is intended for limited distribution to the clients and associates of Oxus Research & Advisory Services Private Limited. Use or distribution by any other person is prohibited. Copying any part of this publication without written permission of Oxus Research & Advisory Services Private Limited is prohibited.

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice.

A number of the comments in this document are based on current expectations and are considered “forward-looking statements”. Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of Oxus Research & Advisory Services Private Limited’s best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

© Oxus Research & Advisory Services Private Limited 2011. The logo and Oxus Research & Advisory Services are among the registered and unregistered trademarks of Oxus Research & Advisory Services Private Limited. All rights reserved.

www.oxusinvestments.com

