

## **It doesn't matter**

Inflation: An Ex-Problem ?

By

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*Blurb: There is considerable evidence to suggest that the Indian inflation problem is a has-been problem, a problem that has ceased to be.*

Just released data on WPI indicates that for the week ended March 2, 2007, year on year inflation was a high 6.46 %. On release of the data, markets went into a tizzy with the Sensex dropping 230 points before “recovering” to 140 points down. This latest inflation data seemed to confirm the conventional wisdom (even street hawkers talk about it) that inflation in India is out of hand, too high, and the government is not doing enough. Even some “market” economists, so-called CPM economists, and economists in the pink papers, have been claiming that the *current* rate of inflation is too high. The pressure by the economics community has been fierce; but not as fierce as the pressure from the economically expert politicians who believe that the Congress lost the elections because the current inflation rate was too high. Little surprise, therefore, that the Finance Minister, in his Budget speech on Feb. 28 and afterwards, gave in to this expert opinion. And offered to stab the mysterious inflation by even more mysterious means.

There is no question that inflation has over-stepped its bounds in India. Six percent is too high, especially given that our self-defined tolerance level for inflation is between 4 and 5 percent. The question, remains, however, whether this high inflation is continuing. If yes, why, and what are the appropriate policy measures. If it is not continuing, then what is the current underlying inflation rate, and what we can expect in the months ahead. It is my contention that the excess inflation of 1.5-2 % that we have observed, and are observing, is an ex-problem. A problem that, as Monty Python would say, has ceased to be, and do I dare say it, that is no more.

Inflation occurred in India in April-June, and September 2006, on the back of two supply side shocks. Oil prices went up by 15 percent between March and June 2006 - from \$ 63 a barrel to \$ 71 a barrel. International wheat prices, after being in a dormant range for

several years, increased by 25 percent in 2006. India was not immune to these international currents. The monthly price index for these two items, along with the index for cement and all commodities, is shown in the table.

What makes compelling reading is the inflation observed since March, June and September of last year. Since end-March is the conventional wisdom – inflation is at a 6.2 percent rate. Since June, the observed inflation rate is 2.9 percent for 8 months, or a 4.3 percent annual rate. Since September is the real Monty – inflation at only 0.3 percent, or a 0.8 percent annual rate. How is this number derived? The inflation in the index is  $209/208.3$  or only 0.3 percent. But this is for five months. Annualized, for 12 months, this pace becomes 0.8 percent. Think about it – for the last five months, after the hump of supply shock in wheat, inflation is only at 0.8 percent.

But wait a minute, you rightly say. We all know that there are seasonal factors affecting inflation, and this can cause any havoc to “annualized” adjustments. True. Which is why in the US, price data are only presented on a seasonally adjusted basis. In Europe, like in India, the statistical situation is somewhat “backward”. There, and here, people actually believe that year on year inflation (as reported in the media and used by several economists and all the journalists) incorporates seasonal factors, when it does nothing of the sort. As the data in the table clearly show.

If the inflation norm for India is taken as 4.5 percent (in the middle of the RBI range of 4 to 5 percent), then if all months are equal, the expected inflation in each month should be  $4.5/12$  or 0.38 percent per month. But all months are not created equal. These seasonal adjustments suggest that observed 8 month inflation between July and February is typically 1.6 percent less; between September and February (5 months), about 3.5 percent less than the “normal” annual rate of 4.5 percent. The observed inflation from July to February (both months inclusive) is 2.9 percent, or an annual rate of 4.5 percent. In other words, since July 2006, inflation in India, much before the RBI’s concern about overheating, was actually well within its stated target. For the later period October to now, and after the “hump” caused by wheat price inflation, the actual inflation is only 0.3 percent compared to an “expected” seasonally adjusted inflation of 0.7 percent. In other words, 0.7 percent for the five months October to February “seasonally” translates into a 4.5 percent inflation. Actual inflation has been less by 0.4 percent over

5 months or less by 1 percent annualized. In other words, inflation since September 2006 has been running at a rate of only 3.5 percent per year (4.5 – 1 percent). No matter how you slice it, the inflation rate since the hump of April-June 2006 (and a mini-hump in September) is well within the RBI target, and most likely, lower than 4 %.

It is in this regard that the inflation problem that the Finance Minister spoke about on Feb. 28<sup>th</sup>, and for which he gave a contorted explanation and even more contorted policies, is an ex-problem. However, he has been stating (correctly in my view and even more correctly according to the analysis presented here) that inflation is well-contained. So look for inflation to fall and for the government to take credit for its anti-inflation policies e.g. banning wheat and rice futures, telling cement makers to behave or else, tinkering here and a band-aid there. But we all, I think, know better. Or soon will. When that happens, please remember that the decline in inflation started well before the budget of 2008, and somewhat before the RBI started to be aggressive in raising interest rates and restricting credit. Did high inflation occur because of over-heating in the economy? Or did it occur due to international supply shocks in wheat and fuels, which has nothing to do with overheating domestic demand?

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## Inflation – Is it still a problem?

	Wholesale price index			All commodities	
	Wheat	Fuel	Cement	WPI	Inflation
Jan'06	205.5	310.8	168.2	196.3	-6.0
Feb'06	209.0	314.1	174.1	196.4	1.2
Mar'06	209.4	315.5	181.8	196.8	2.4
Apr'06	198.9	317.0	191.2	199.0	13.2
May'06	199.2	320.1	193.5	201.3	13.2
Jun'06	200.0	324.7	193.6	203.1	10.8
Jul'06	201.1	326.9	194.5	204.0	4.8
Aug'06	207.4	328.8	195.0	205.3	7.2
Sep'06	216.8	329.6	194.6	208.3	18.0
Oct'06	221.2	328.7	196.8	208.9	3.6
Nov'06	229.3	326.7	198.8	209.1	1.2
Dec'06	234.3	321.9	198.6	208.1	-6.0
Jan'07	233.2	322.1	198.3	208.8	3.6
Feb'07	232.0	318.9	200.6	209.0	1.2
<i>Percent increase in index</i>					
Mar'06 - Feb'07	10.8	1.1	10.3	6.2	
Jun'06 - Feb'07	16.0	-1.8	3.6	2.9	
Sep'06 - Feb'07	7.0	-3.2	3.1	0.3	

Note: The numbers in the final column is monthly inflation multiplied by 12 to yield the annualized Inflation rate for that month.