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The state of price and inflation in India

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Despite differing monetary policy goals and actions, inflation reached multi-decadal highs in various nations. As the economic activity improved in the second year of the pandemic, the global economy was confronted with a new challenge: growing worldwide inflation. Inflation rose in several advanced and emerging economies due to COVID-19-related stimulus spending in key economies combined with pent-up demand boosting consumer spending. The picture becomes hazier as financial market volatility and geopolitical tensions, such as the ongoing Russian invasion of Ukraine, mount in the recent period. Globally, in advanced economies, inflation has risen from 0.7 per cent in 2020 to 3.1 per cent in 2021. India is no exemption. According to RBI, despite a highly transmissible third wave caused by the COVID-19 Omicron variant, India is on a different path to recovery than the rest of the world.

This article reviews the Economic Survey 2021-22, Chapter 5: Prices and Inflation. In particular, we discuss the recent trends in CPI and WPI inflation, the divergence between both inflation measures, factors contributing to CPI and WPI inflation, and perspectives for long-term inflation, where we touch upon various upside risks to inflation emanating from geopolitical tensions.

The behavior of retail inflation

The Economic Survey 2021-22 highlighted that the CPI-combined inflation[1] (henceforth, CPI inflation) is at a moderate rate (5.2 per cent) in 2021-22 compared to previous years. The reduction in the CPI inflation is due to the downfall in food inflation. As measured by the Consumer Food Price Index (CFPI), food inflation was at an all-time low of 2.9 per cent in 2021-22 (April to December), compared to 9.1 per cent in 2020-21 (April to December). Food inflation remained in control during most months. It increased to 4 per cent in December 2021.

However, retail core inflation in 2021-22 tells a different story. Since fuel and food prices are volatile and noisy, it does not help the central bank (i.e., RBI) in inflation management. Thus, conventionally, 'food and beverages', and 'fuel and light'[2] groups are excluded from the overall inflation (or the headline inflation) to arrive at the measure of core inflation. Retail core inflation has been on the rise this fiscal year. The average core inflation rate for April to December 2021 was 5.9 per cent, which was marginally higher than last year's corresponding period. It remained below 6 per cent during most months.

This measure of 'core inflation' has its drawbacks which the Survey highlighted in this year's report. The Survey mentioned that a measure anomaly in the current measure of core inflation is that it still continues to include volatile fuel items. As of result of this, the Economic Survey argued and demonstrated that the fuel price rise continues to impact core inflation. Thus, the Survey has proposed a new measure of core inflation which neatly calculates the underlying inflationary pressure on the economy. This will be very helpful to the central bank in its interest rate policy. They explained the following rationale for using such a new measure.

The 'fuel and light' group in CPI-C does not include major fuel items having relatively large weights, such as 'petrol for vehicle' and 'diesel for vehicle'. They are included in the transport

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[1] RBI releases three measures of inflation, each catering to different population group. They are CPI-R (for Rural area), CPI-U (for urban area), and CPI-C (combined inflation for all India).

[2] Fuel and light' consist mainly of items of household's consumption such as electricity, LPG, Kerosene and other fuels used for cooking. On the other hand, petrol and diesel used for vehicles is included in the 'transport and communication' sub-group of the miscellaneous group.

and communication group, not in the fuel and light group. Therefore, the conventional computing retail core inflation includes volatile fuel items. To eliminate this, Economic Survey constructed refined core inflation which removes major fuel categories from headline retail inflation, such as 'petrol for vehicles', 'diesel for vehicles', and 'lubricants and other fuel vehicles', in addition to 'food and beverages', and 'fuel and light'. It showed that since June 2020, refined core inflation has been significantly lower than conventional core inflation, demonstrating that fuel inflation has dramatically impacted the conventional core inflation gauge.

Major drivers of CPI inflation

The key drivers of retail inflation in 2021-22 (April-December) were found in 'miscellaneous' and 'fuel and light' categories. Miscellaneous group contributions climbed from 26.8 per cent in 2020-21 (April-December) to 35 per cent in 2021-22 (April-December), while "fuel and light" contributions increased from 2.3 to 14.9 per cent. During the same period, however, the contribution of 'food and beverages' fell from 59 per cent to 31.9 per cent. The most contributions came from the "miscellaneous group" sub-category 'transport and communication', followed by health.

In 2021-22, inflation in 'fuel and light' and 'transport and communication' was driven mainly by high international crude oil prices, petroleum product prices, and higher taxes. The increasing trend in crude oil prices was due to OPEC and other oil-producing countries cutting crude oil supplies to historic levels. In 2021, the declining trend continued as demand increased due to the lifting of COVID-19 restrictions in most parts of the world. Further, while OPEC+ countries eased production cuts, it has not kept up with the recovery in demand. In India in 2021, a drop in central excise duty on fuel and diesel, followed by a reduction in VAT by most state governments, resulted in a moderated retail selling price of petrol and diesel. However, restricted supply and fears about escalating geopolitical risks in Eastern Europe and the Middle East caused crude oil prices to rise again in January 2022.

Inflation in the 'transport and communication' group is a major contributor to the 'miscellaneous' group, since it includes 'petrol for vehicles', 'diesel for vehicles', the price of which has accelerated significantly. The "miscellaneous" group contributes to roughly 35 per cent of overall inflation in 2021-22 (April-December). Inflation in the "clothing and footwear" category increased during the current fiscal year, primarily due to increasing production and input costs (including imported materials) and a resurgence in consumer demand.

Retail food inflation remained above 8 per cent from November 2019 to November 2020 but then fell to 2.9 per cent in 2021-22 (April-December). According to the 2011 census under the National Food Security Act of 2013, cereal and product inflation remained negative from April to September 2021 and was low from October to December 2021. It indicated a sufficient supply of cereals, aided by an effective public distribution system that provides subsidised foodgrains to the bottom 67 per cent of the population. Inflation in vegetables remained negative at (-)11.3 per cent in 2021-22 (April to December), negatively affecting overall retail inflation. Though, by the end of September 2021, tomato prices soared due to crop damage and a delay in the arrival of fruit in mandi due to unseasonal heavy rains in the producing states, tomato prices, however, have moderated due to fresh supplies in December 2021. Onion and potato inflation remained negative throughout the year. The Survey nicely showed how seasonality and exogenous shocks can impact tomato and onion retail pricing.

Due to COVID-19-related supply disruptions, high poultry feed prices, and high soybean meal prices, inflation in protein-based commodities such as "meat and fish" remained significantly elevated from 2021 to 2022 (April to December). While the average inflation rate for "meat and fish" was 8.0 per cent in 2021-22 (April to December), it was 15.4 per cent in 2020-21. Inflation in "meat and fish" has been falling since September 2021, reaching 4.6 per cent in December 2021, the lowest level in the current fiscal year. Since July 2021, egg inflation has steadily declined, remaining negative in October and November 2021. Inflation in "pulses and goods" remained high in the previous financial year but has been steadily declining since July 2021 due to the government's aggressive supply management initiatives.

Despite weighing only 7.8 per cent in the group, "oils and fats" contributed nearly 60 per cent of the inflation in "food and beverages." The sub-inflation groups have been on the increase since mid-2019, have persisted in double digits since April 2020, and are expected to continue to grow in prices and inflation in 2021-22. From 2021-22 (April to December), inflation was 30.9 per cent, while it was 24.3 per cent in December 2021. This is mainly because India is a major importer of edible oils (nearly 60 per cent). Thus, fluctuation in imports and international prices percolate to higher domestic prices of edible oil. The Survey mentioned that the current spike in prices of edible oils is mainly on account of high and increasing international prices of edible oils.

Divergence between rural-urban inflation

The gap between inflation in CPI rural and CPI urban areas narrowed in 2020. CPI-Urban inflation tracked closely with CPI-Rural inflation in 2020. The two primary divergence points are November 2020 to March 2021 and September 2021. The Survey finds that 'food and beverages' group is a key factor in the divergence trend. This is primarily due to the high weights attributed to the 'food and drinks' group in rural and urban CPIs.

Trend in the wholesale price index

In contrast to the trends found in CPI inflation, WPI inflation has increased and stayed high during the current fiscal year. WPI inflation was low in 2020-21 and 2019-20, mainly due to the pandemic-induced slowdown in economic activity and the record low global crude oil prices and poor demand. The recent surge in wholesale inflation as measured by the WPI could be attributed to a low base in the previous year.

While WPI inflation in the current fiscal year was more significant than the previous year in all three major groups, it was above 20 per cent in the 'fuel and light' group, indicating high worldwide petroleum costs. The impact of increased prices on the WPI manufacturing was evident, particularly in the manufacture of basic metals, which witnessed 27.3 per cent inflation in 2021-22 (April-December). A rising trend in high worldwide crude oil and petroleum product prices resulted from a series of unprecedented cuts in crude oil supply by OPEC in 2021 and other oil-producing countries, resulting in a jump in inflation in the 'fuel and light' and 'transport and communication' groups. As mentioned earlier, India's high import dependence on edible oils also contributes to high inflation since high international prices of these products are also reflected in the domestic prices.

WPI and CPI inflation differential

Since June 2019, the year-on-year inflation rate based on the WPI and the CPI-C has diverged. Wholesale inflation was lower than retail inflation between June 2019 and February 2021, while wholesale inflation was higher than retail inflation between March 2021 and December 2021. WPI inflation was higher than CPI inflation this year, although the gap widened significantly. The WPI-based inflation rate was eight percentage points greater than retail inflation in December 2021. WPI accelerated, reaching 12.5 per cent in 2021-22 (April-

December). The increase in economic activity, the steep rise in international crude oil and other imported input prices, and high freight costs were all factors. As a result of the COVID-19 pandemic's impact, production activity remained subdued in 2020-21, and global crude oil prices dropped to a historic low due to a lack of demand. As a result, the WPI-based inflation rate fell to 1.3 per cent in 2020-21. With economic activity increasing in 2021-22 and global crude oil prices rising, WPI inflation peaked at 14.2 per cent in November 2021 and 12.5 per cent in April-December 2021, thanks to the low base of 2020-21. Consequently, the high WPI-based inflation rate in 2021 is mainly due to the previous year's low base.

While the base effect may play a role in the divergence between the WPI and the CPI, the basic differences between the two indices' purpose and design and the price behaviour of the individual components of the two indices can also offer some clues to the current divergence. Consumer purchasing behaviour is reflected in the CPI, generated from household consumption patterns using the NSS Household Consumer Expenditure Survey, and reflects price changes at the retail level. The WPI-based inflation rate, on the other hand, is calculated using the percentage of the corresponding items in total wholesale transactions in the economy at the first point of sale. CPI-C and WPI inflation discrepancies remained a point of contention in 2022. The Survey pointed out that along with base effect differences in scope and coverage of the two indices, their price collections, items covered, and differences in commodity weights can be reasons for the divergence.

Perspective for long-term

The last portion of the Survey discusses the long-term supply-side policies to control inflation. It includes changes in production pattern, calibrated import policy, and transportation and storage facilities of perishable commodities. The production pattern change encourages farmers to switch from rice and wheat to pulses and oilseeds, which would enable the country to become pulses and oilseeds self-sufficient while reducing reliance on imports. By shifting output to pulses, the government will be able to keep realistic rice and wheat buffer stockpiles. The government has recently prioritized increased pulse and oilseed production, which it has accomplished through area expansion, productivity through HYVs, MSP support, and purchasing.

This year's Economic Survey suggested some measures to control inflation by managing supply-side factors. While seasonality is vital in the case of vegetables, unexpected events such as untimely rains impact their availability and prices. A strong network of cold storage chains supported by adequate transportation infrastructure is required to stabilize the prices of perishable commodities. During the year, effective supply-side management kept the prices of the essential goods under control. Further, the Survey suggested implementing specific proactive actions to contain price increases in pulses and edible oils, which had witnessed inflation due to imported inflation. Self-dependence on edible oils is much needed. The government should incentivise the production of these products by providing various subsidies.

Import duty and tariff modifications in response to price increases in vital commodities such as pulses and edible oils while offering immediate respite to consumers at lower prices send wrong signals to domestic producers and create an unstable environment. A consistent long-term strategy is required. For a stable domestic climate, the government negotiated a Memorandum of Understandings (MoU) with pulse-producing countries. The MoUs would ensure that the quantity of pulses produced and sold to India is predictable, which will benefit both India and the pulse-exporting country. Specific alternative measures to tackle the overdependence of these commodities on the part of the government are most appreciated, such as subsidizing the domestic alternatives for the inflationary products. After sixty-six years of planned economy, India still struggles to provide adequate storage and transport facilities to the agriculture sector.

Concluding remarks

There are many upside risks to inflation. First, amid geographical uncertainties in Eastern Europe and Middle East countries, especially ongoing extended Russia's invasion of Ukraine, many economists and policy-makers are concerned about how it would affect retail inflation in India. To put it in the context, India imports over 80 per cent of its crude from other countries, and thus, the unpredictable market may have an overriding effect on consumer goods pricing. The effect of Russia's assault is already playing out in terms of higher inflation. The WPI inflation in March 2022 surged to 14.55%, while CPI inflation touched 6.95% in March 2022, much above RBI's upper tolerance level of 6 per cent.

A recent survey conducted by the IGM Forum at Chicago Booth, which regularly polls some of the world's top economic experts in Europe and the US for their views on topical issues of public policy, asked the panelists whether the Russian invasion of Ukraine would be stagflationary. Over three-quarters of the panel agree that the fallout from the invasion will both reduce global growth and raise global inflation over the next year. A higher average global inflation would feed to higher domestic inflation.

Second, the Union government is planning to borrow about Rs 11.6 lakh crore from the market in 2022-23 to meet financing a massive capital expenditure plan. This comes on the back of record market borrowing in the last year. This has sparked fears among bond dealers that inflation will accelerate. With global crude oil prices near seven-year highs, the government's plans may force the RBI to act sooner rather than later.

The consequence of sustained rising inflation is that it would hard-press the RBI to raise rates to combat rising inflation below the upper band of 6 per cent. This may hinder real economic recovery, which is making a gradual comeback. One way to ease off the pressure on retail inflation is that the Union government should roll back excise duties on fuel prices from petrol and diesel to CNG and LPG prices for the following reasons. First, the Union government raised various excise duties amid the pandemic-induced collapse in the fuel tax revenue. The recent data suggests that the Center's total gross tax revenue collection for 2021-22 touched Rs.27.07 lakh crores, almost Rs. 5 lakh crores above the budget estimate of Rs. 22.17 lakh crore. Further, month-wise GST collection is growing at a robust pace thanks to better compliance, use of data analytics and Artificial Intelligence, and enforcement action against tax evaders. Second, the prospects of economic recovery seem well and going by GST collection data; it is projected to grow at a healthy pace assuming any further variant of the coronavirus does not pose a significant threat to the ongoing recovery process. Third, demand for oil consumption and oil prices have risen steadily. This implies that the Center's tax revenue from petroleum products is robust and will rise further. Considering all these factors, the Center can afford a cut in excise duties.

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