

INDIA

# A Fresh Surge In India's Inflation Crisis

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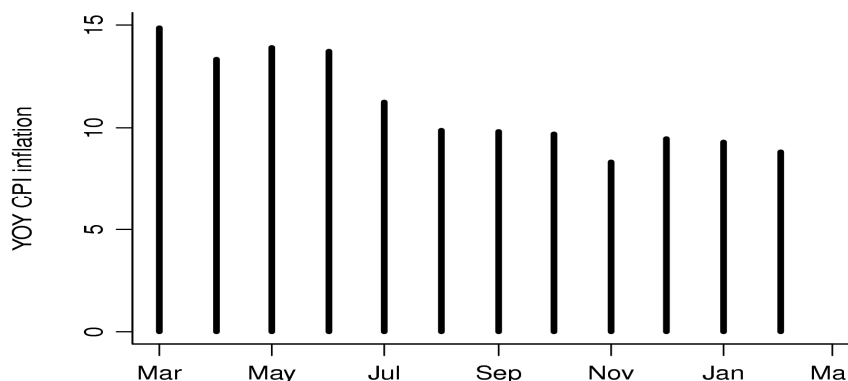
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## Room For Optimism?

In recent months, there has been some optimism about inflation, given a slight easing of year-on-year inflation.



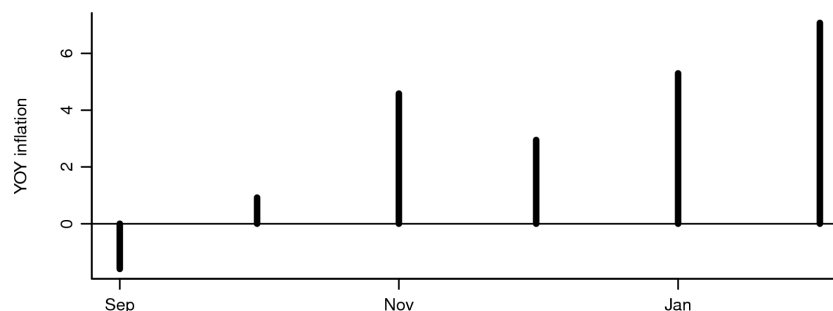
The graph above shows the time-series of year-on-year inflation using the CPI-IW, which is the best inflation measure in India. This seems to show a deceleration in inflation from 15% in March 2010 to below 10% in February 2011.

Similarly, year-on-year inflation for the widely watched Wholesale Price Index (WPI) has decelerated from 11% in April 2010 to the latest value of 8.31% for February 2011.

However, the outlook for inflation remains grim.

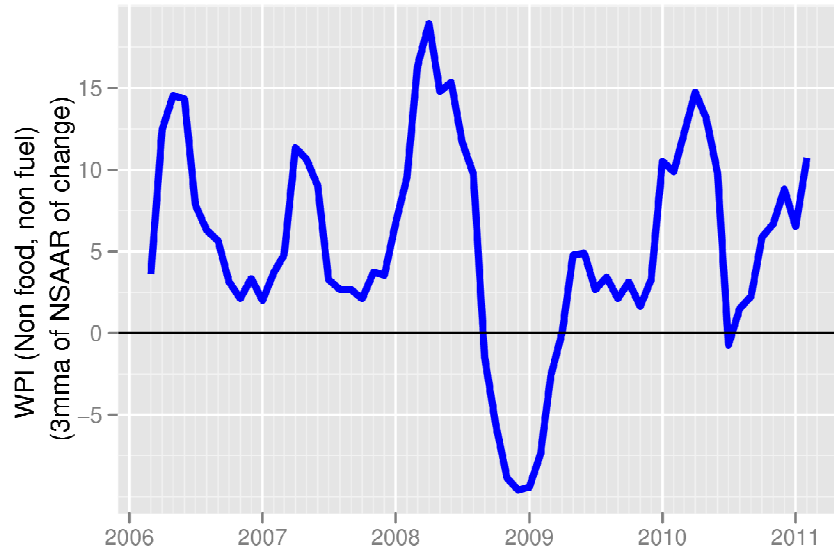
## Tradeables Inflation

We first examine external influences, which are conveniently summarised as the US PPI translated into rupees. This reflects fluctuations of US PPI, which measures the global price of tradeables, and fluctuations of the INR/USD exchange rate. In recent months, this has resurged:



This shows that year-on-year inflation of India's tradeables, expressed in rupees, has resurged from roughly 0 in October 2010 to above 6 per cent.

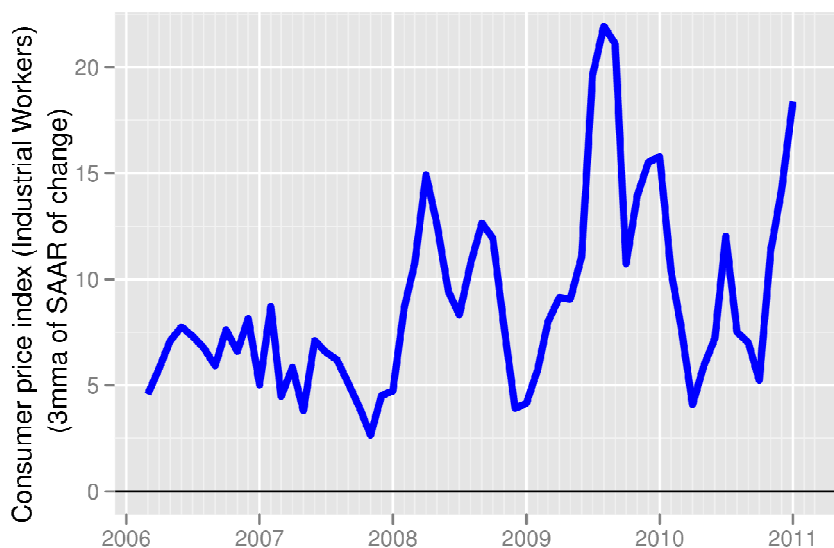
This is generating pressure for tradeables inflation. We now turn to the best measure of tradeables inflation: the non-food, non-fuel component of the Wholesale Price Index. The picture for month-on-month seasonally adjusted changes is as follows:



Each point in this graph is the average of three month-on-month changes in the WPI (ex fuel and ex food). This has resurged from zero to above 10%.

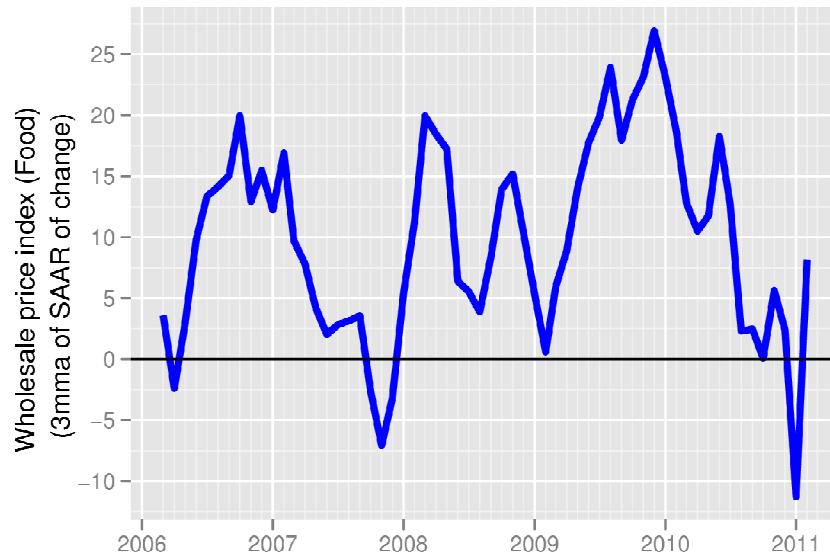
### Overall Indian Inflation

This is helping inspire a fresh surge in the CPI-IW:



Each point in this graph is the average of three month-on-month changes in the CPI-IW. This had ebbed to sub-10 values (and was reflected in a gradual ebbing of year-on-year CPI-IW inflation). But this has now resurged to 18%. This is inevitably going to kick off a period of accelerating year-on-year CPI-IW inflation.

## Despite Relative Comfort On Food Inflation



For some time, the Indian authorities were claiming that India's inflation problem was entirely about food inflation, and the problem of CPI-IW inflation was primarily about the high weight of food in the CPI-IW. However, as the graph above shows, while high food inflation was a problem in late 2009, food inflation has behaved relatively well of late. This convenient excuse can no longer be sustained.

## Implications

India has come into a difficult period where inflationary expectations are getting woven into expectations. Monetary policy is no longer conflicted by exchange rate policy (the RBI has not traded in the rupee-dollar market for the last two years). But a clear monetary policy strategy has not been put into place.

In coming months, the political situation is going to be fraught with a set of elections taking place in Assam, Pondicherry and the important states of Kerala, Tamil Nadu and West Bengal. Bad news on inflation will matter directly to voters there. In addition, bad news on inflation will be used by the political wing of the Congress as ammunition in their criticism of Prime Minister Manmohan Singh: it will be argued that the Prime Minister is not performing his end of the bargain, that of delivering a well functioning economy.

The Prime Minister will, in turn, be very focused on inflation. This would involve higher interest rates. It could also involve a less exuberant fiscal stance.

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