Prices and Inflation: Chapter-5

CURRENT TRENDS IN INFLATION

The global economy has been witnessing a steep decline in inflation over the past five decades. Inflation has declined in almost all the countries around the world. Emerging market economies have also experienced a remarkable decline in inflation over the same period.

Reasons: Adoption of a more resilient monetary and fiscal policy frameworks, structural reforms of labour and product markets that strengthen competition, and adoption of monetary policy framework for inflation targeting.

In India, inflation has been witnessing moderation since 2014. There has been a shift in inflation dynamics too. The average levels of inflation have fallen considerably since 2013-14. At the same time the peak levels of inflation achieved in a particular year has been much lower lately. Further, there is convergence of headline inflation (includes volatile items like food and fuel) towards core inflation from 2012 onwards as per CPI-C.

[CPI-C is CPI-Combined (Rural+Urban)]

Headline inflation based on CPI-C has been sliding on a downward path since 2014. The average CPI-C headline inflation, which was 5.9 per cent in 2014- 15, has fallen continuously to around 3.4 per cent in 2018-19. This has been led by a drastic fall in food inflation.

In 2019-20, there has been slight uptick in the headline and food inflation numbers. Overall, CPI -C headline inflation in 2019 stood at 7.4 per cent, while CPI-food inflation increased to 14.1 per cent mainly driven by the rise in vegetable prices. Core (non-food non-fuel) inflation has also increased to 3.8 per cent in December 2019.

During 2019-20, WPI based inflation has been on a continuous fall declining from 3.2 per cent in April 2019 to 0.6 per cent in November 2019, but increased to 2.6 per cent in December 2019.

Since 2018, CPI-Urban inflation, has been consistently above CPI-Rural inflation. This is in contrast to earlier experience where rural inflation has been mostly higher than urban inflation. The divergence has been mainly on account of the differential rates of food inflation between rural and urban areas witnessed during this period.

Divergence in rural-urban food inflation in 2019-20 was mainly led by cereals, eggs, fruits, vegetables etc. The slide in rural inflation could be because of fall in the growth of real rural wages. The divergence in rural-urban inflation is not just observed in the food component but in other components too, like clothing and footwear. Where inflation in urban areas was higher than that observed in rural areas.

However for items like Pan, tobacco & intoxicants, fuel and Miscellaneous groups, inflation observed in rural areas was higher than that in the urban areas.

Miscellaneous basket comprises of household goods and services, health, transport and communication, recreation and amusement, education, personal care and effects.

But due to the high overall weight attached to the food and clothing & footwear groups in the rural index, the overall inflation observed in rural areas was lower than the overall inflation observed in urban areas 2019-20.

The decline in rural inflation in items like clothing and footwear, fuel and light could be due to fall in growth of real rural wages, while rise in rural price index for items like education, health, personal care etc. also raises the question of affordability of these items to the rural segment.

INFLATION IN STATES

CPI-C inflation has continued to be highly variable across States. Inflation ranged between -0.04 per cent to 8.1 per cent across States/UTs in financial year 2019-20. The variability has increased in 2019-20 as compared to what it was in the year 2018-19.

But the overall inflation rate has been quite low in almost all the States. As compared to 2018-19 nineteen States/UTs had inflation rate lower than All India average in 2019-20 with Daman & Diu having the lowest inflation followed by Bihar and Chhattisgarh.

Though in most of the states the overall inflation rate in rural areas is lower than the overall inflation rate in urban areas, the variability of rural inflation has been observed to be very high as compared to urban inflation. This could explain the fact that some states might actually have inflation in rural areas higher than inflation in urban areas despite the average rural inflation being lower as compared to the average inflation for urban areas at an All India Lvel.

This seems to be the case in a lot of states like Punjab, Haryana, Uttarakhand, Delhi, Rajasthan, Uttar Pradesh, Madhya Pradesh, Nagaland, Tripura and Kerala.

DRIVERS OF INFLATION

During 2018-19, the major driver of CPI-C inflation was the miscellaneous group (defined previously). Compared to 2017-18, the contribution of food and beverages to total inflation was lower in 2018-19. However, during 2019-20, **food and beverages emerged as the main contributor to inflation**, with 54 per cent of the inflation during this period attributable to this group. Miscellaneous group was the second largest contributor to inflation during this period.

CRUDE OIL AND FUEL INFLATION

During April-December 2019, world crude oil prices declined owing to weak global demand. As oil has a major share in the country's import basket, it impacts considerably domestic prices of petroleum products. The mineral oils group in WPI declined substantially due to this. The fuel components of CPI also show a movement in a similar direction.

DRUG PRICING

Out of the total out of pocket expenditure of individuals on health, the major portion is that of medicines. This makes the provision of affordable drugs an imperative. The Government came out with National Pharmaceutical Pricing Policy, 2012 with an objective to put in place a regulatory framework for pricing of drugs so as to ensure availability of required medicines – "essential medicines" – at reasonable prices.

National Pharmaceutical Pricing Authority (NPPA) has so far fixed the ceiling prices of 860 formulations/packs of drugs as well as on crucial medical instruments resulting in tremendous benefit to the people in terms of savings in out of pocket expenditure.

FOOD INFLATION

Food inflation has been the major driver of inflation during the current financial year 2019-20. Some commodities such as onion, tomato and pulses have shown high. Untimely rains have caused lower production as well as constricted the movement of onion and tomato to the markets. In the case of pulses, the progress in sowing has been at much lower levels than in the previous year.

Onion

Both WPI and CPI based Inflation rate of onion showed steeply increasing trend in 2019 as compared to last year.

Reasons:
Demand-Supply mismatch further exacerbated by a fall in area sown and damage to Kharif onion due to heavy rains in September/October, 2019 as reported from major Kharif growing States Maharashtra, Karnataka, Madhya Pradesh, Andhra Pradesh, Gujarat and Rajasthan.

Tomato

CPI based Inflation rate of Tomato too showed an increasing trend in 2019 as compared to last year.

Reasons:
Excess rains in Maharashtra and Karnataka etc. which are major producers of tomato thus disrupting the supply of tomato and resulting demand supply mismatch.

Pulses

The CPI inflation rate of pulses increased from -20.2 per cent in January 2018 to 15.4 per cent in December 2019.But the current hike in prices of various pulses compared to their long-term trends is not very high.

Reasons:

Fall in acreage resulting from rains in the growing states and low price realisation due to glut in the market following increased production of earlier years. Low market prices during 2018-19 may have resulted in significant reduction in acreage of some pulses.

VOLATILITY IN ESSENTIAL COMMODITY PRICES

Wholesale price volatility was analysed for various essential commodities over two time periods i.e. 2009-14 and 2014- 19. Coefficient of variation has been used as a measure of volatility.

- Prices of rice and wheat remained stable (less volatile) since 2014 due to sufficient domestic production and maintenance of adequate buffer stock for food security requirements.

- Overall price volatility was highest for vegetables and lowest for rice, wheat and palm oil.

- There was a significant rise in volatility for pulses, sugar and tomatoes during 2014 - 2019.

The extent to which given production and consumption shocks translate into price volatility depends on supply and demand elasticities. Stockholding and speculation can have major impact on price variability. Perishability of the commodities also adds to price volatility. Presence of marketing channels, storage facilities, and effective MSP system can help limit price volatility.

DIVERGENCE IN RETAIL AND WHOLESALE PRICES FOR ESSENTIAL AGRICULTURAL COMMODITIES

A divergence between the retail and wholesale price of various essential commodities (arhar, gram, groundnut oil, vegetables etc.) was observed in the four metropolitan cities of the country over the period 2014 to 2019.

The price wedge ranges from 10 to 59 percent across various metro cities. Spreads in prices is maximum for vegetables that are perishable, then for pulses and the least for edible oils.

The reasons for such a high spread between the wholesale and retail prices could be due to several reasons such as high transaction costs, weak infrastructure and information systems, poor marketing facilities, huge margins of middleman etc.

Another possible reason for this could be asymmetry in the transmission of price signals from wholesale to retail prices and vice versa, this can happen due to action of intermediaries. Therefore, to reduce the wedge it is important that market barriers and structural rigidities in the system that lead to higher transaction costs are removed.

HAS THERE BEEN A SHIFT IN INFLATION DYNAMICS?

After witnessing high levels of inflation during 2012-13, CPI-C inflation fell in 2013-14 and witnessed a drastic fall from 2014-15 onwards. Given the falling trend in inflation in the recent years, it is pertinent to ask whether there has been a shift in the inflationary process. The average levels of inflation have fallen considerably during this period. Not only have the average levels of inflation come down, the peak levels of inflation during the financial year are now much lower.

It has been generally believed that, food and fuel inflation in India have had strong secondary effects leading to persistence in household inflation expectations. This feeds into core inflation and therefore prolongs the effects on headline inflation.

One way to check for the presence of secondary effects of food and fuel inflation is to look at the swiftness with which headline inflation converges to core inflation after the occurrence of a food or fuel price shock. If headline inflation does not completely revert back to core inflation within a reasonably short span of time, it may indicate the presence of strong secondary effects.

The reversion of headline inflation to core inflation has considerable implications for the conduct of monetary policy in an inflation targeting framework. In an economy with strong secondary effects, monetary policy may have to be tighter in an event of a food or fuel price shock compared to an economy where such effects are minimal.

It was observed that from 2012, there is convergence of headline towards core inflation as per the CPI-C data. The analysis for monthly CPI-C inflation data between January 2012 and November, 2019 was done.

The results indicate that in the period under consideration there is evidence of strong reversion of headline inflation to core inflation. The data indicates complete reversion of headline inflation to core within a period of 12 months. A similar regression to test for the reversion of core to headline inflation does not provide evidence for the same.

This implies that secondary effects from non-core components to core components are minimal. **This may have implications for the response of monetary policy to food and fuel price shocks: monetary policy need not become tighter in face of short-term, transitory price shocks in non-core components**.

However, owning to the large weightage of food and fuel in the consumption basket of consumers in India and the fact that demand-side pressures (and not just supply side factors) are important for food and fuel inflation-focus on headline inflation for monetary policy decisions may be warranted.

Two major factors could have contributed to the changing dynamics of inflation in India.

First, it was observed that food inflation has seen a declining trend during the period under consideration. The decline in inflation has been witnessed in most categories of food group such as cereals and products, fruits, vegetables and pulses.

Second, inflation expectations have been declining since 2015 partly because of the success of inflation targeting approach of monetary policy adopted by RBI in anchoring inflation expectations. On the other hand, household inflation expectations are known to move closely with food inflation. The fall in food inflation during this period could have had the effect of reducing the overall inflation expectations of the households.

TRENDS IN GLOBAL COMMODITY PRICES

Energy commodity prices have shown a decreasing trend in 2019-20. In terms of food prices, the deflationary trend continued. The metals and minerals index also showed a deflationary trend too, indicative of the gloomy global economic scenario prevalent during the year.

MEASURES TO CONTAIN PRICE RISE OF ESSENTIAL COMMODITIES

Government takes various measures from time to time to stabilize prices of essential food items which include utilizing trade and fiscal policy instruments like import duty, Minimum Export Price, export restrictions, imposition of stock limits and advising States for effective action against hoarders & black marketers etc. to regulate domestic availability and moderate prices.

Also, Government incentivizes farmers by announcing Minimum Support Prices for increasing production and is implementing Schemes which include Mission for Integrated Development of Horticulture (MIDH), National Food Security Mission (NFSM), National Mission on Oilseeds and Oil Palm (NMOOP), etc. for increasing production and productivity through appropriate interventions.

Besides, Government is also implementing Price Stabilization Fund (PSF) to help moderate the volatility in prices of agri-horticultural commodities like pulses, onion, and potato

• During 2019-20, buffer stock of onion was created under Price Stabilization Fund (PSF) through procurement from Maharashtra and Gujarat which was distributed to various State Governments, other agencies and also sold in various mandis through open auction.

• Onions were supplied to State Governments of Haryana, Kerala, Andhra Pradesh and Uttar Pradesh at no-profit no-loss basis to improve prices and availability situation. During 2019 onions were supplied from the buffer stock for direct retailing in Delhi-NCR through Mother Dairy, NCCF, NAFED and Govt. of NCT of Delhi at regulated retail rates to ensure availability of onions at reasonable prices.

• The benefit to exporters of onions under Merchandise Exports from India Scheme (MEIS) was withdrawn w.e.f. 11th June 2019.

• Minimum Export Price (MEP) was imposed on onion in 2019, and subsequently its export was banned by Government in view of its continued high prices.

• Government imposed stock limits on traders across the country – 100 quintals on retail traders and 500 quintals on wholesale traders under the Essential Commodities Act, 1955, which was subsequently, revised to 20 quintals (2 MT) for retailers and 250 quintals (25 MT) for wholesalers.

Further, Government of India urged State Governments to hold regular meetings with the traders of Onions at State and District level to prevent hoarding, speculative trading and profiteering, unfair and illegal trade practices like cartelling, etc.

• Facilitated private imports of onions by relaxing its fumigation norms and exempting importers from stock limits from countries like Egypt and Turkey.