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India's Inflation: An Alternate Hypothesis

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Abstract

Inflation continues to remain the biggest challenge for economic policy in India. This paper analyses various factors contributing to inflation. It argues that rapid growth of a cash economy fuelled by heavy liquidity and large cash transactions, particularly in property markets, are sustaining inflation. Under such circumstances, monetary policies are likely to be ineffective in curbing prices.

In India, the major index of inflation, or what is considered to be the 'headline inflation number,' is the WPI (Wholesale Price Index). There is also the CPI (Consumer Price Index), but there are four different types of CPI indices and this makes it fairly unwieldy. The four are: CPI for Industrial Workers (CPI-IW); CPI for Urban Non-Manual Employees (CPI – UNME); CPI for Agricultural Labourers (CPI-AL); and CPI for Rural Labour (CPI-RL). India is about the only major country that uses a wholesale price index. Almost every other country uses the CPI as a measure of inflation, as this actually measures the increase in price that a consumer will ultimately have to pay for. The weights of items in the CPI and WPI baskets are calculated based on detailed surveys and other calculations. The WPI is published on a weekly basis and the CPIs, on a monthly basis.

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Inflation indices are only as good as how well they are constructed[2] and the different weights that are assigned to the items in the basket. The inflation rate can, in theory, be manipulated by adjusting the weights of certain commodities. Another problem sometimes with an inflation index, and by definition the inflation rate, is that it can suffer from what is the base effect. Since inflation is typically calculated on a year-on-year basis, the inflation rate always depends on the base and that can sometimes either exaggerate or underplay the inflation rate.

The WPI in its role as a guide to policy formulation has several critical imitations that include non-inclusion of services, following a fixed weighting scheme while the economy is undergoing major structural changes, and the inability to capture data on final purchases by the consumer. If one actually looks at the CPI basket in the United States, rent has a fairly high weight. Also, the fact that nearly every country uses CPI as a measure of inflation clearly indicates that CPI is a better index.

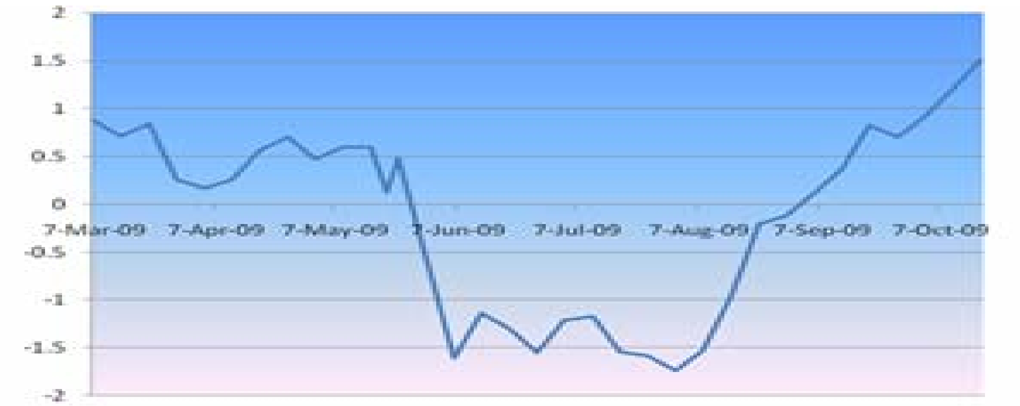

Figure 1: Monthly Inflation in India based on WPI (March-October 2009)

Inflation has been high all through 2009. The situation worsened during 2010. Food inflation jumped from 8.6 per cent during the week ending of 27 November 2010 to 9.5 per cent for the week ending 4 December 2010. It then increased to 12.1 per cent in the following week and further to 14.4 percent in the week ending 14 December, due to high prices of onion and milk.[3]

Monetary policy actions in any country are based on the inflation rate. But in India it can be argued that monetary policy is being done looking at the wrong inflation rate. In fact, during December 2010, the CPI was higher than the WPI. This should mean that the interest rate should be higher than what it is now. Last year, the Reserve Bank of India (RBI) hiked policy rates six times to curb inflation, but in its review in December, RBI did not[4] increase the key rates due to the tight liquidity situation.

2 http://advances.mse.ac.in/making/WPI%20Evolution%20of%20the%20Weighting%20Diagrams.pdf. Accessed on 10 January 2011.
3 *The Hindu Business Line* (5 January 2011).
4 *Monetary Policy Review*, Reserve Bank of India (16 December 2010).

The persistent inflationary pressures are becoming a source of major concern for the economic policymakers as well as the politicians. There appears to be several facets to the problem that are exacerbating the difficulties in managing the situation.

The fiscal policies of the government, since 2008, have been expansionary. In 2008-09, the budget provided for the write-off of agriculture loans, an extension of subsidies for oil and fertilizer, an expansion of the flagship National Rural Employment Guarantee Programme (NREGP) and an increase in the Minimum Support Price (MSP) to agricultural products, particularly rice, wheat and cotton. These measures were coupled with relaxation in financial markets by allowing more derivative and future products, greater flexibility for external commercial borrowings (ECBs) and an increased lending programme for infrastructure projects. All these measures induced substantial liquidity into the markets. Most importantly, the direct grants to smaller towns and rural areas have expanded the operations of the cash economy in these areas. It must be emphasised that most rural areas, especially in the fertile rice and wheat growing regions of Bihar and Uttar Pradesh, are underbanked, and traditionally, economic transactions are carried out in cash. Further, there are no taxes on agricultural production. Hence, the entire agricultural sector in India which constitutes around 20 per cent of the Gross Domestic Product (GDP) is essentially cash-generating and a cash economy sector. In short, government policies and schemes have resulted in substantial cash being injected into rural areas and small towns in the last two years. For example, the allocations under the NREGA (National Rural Employment Guarantee Act) have been close to US$10 billion for each of these two years and have been in form of cash grants for unskilled labour.

At the same time, receipts from disinvestment in Public Sector Undertakings[5], sale of 3G spectrum and robust taxation revenue, coupled with a slowdown in planned expenditure, has resulted in governmental balances with the RBI being substantially positive, as at the end of November 2010. At the corporate and bank levels, therefore, there has been a shortage of liquidity and banks have increased interest rates for medium term deposits. This has turned the monetary stance of the RBI into a cautious one. At one level, they are watching the inflation very carefully, fully aware that these pressures could well jeopardise the growth story. At another level, the shortage of liquidity is affecting business sentiments and overnight call money rates and kerb money rates are ruling at all time high.

There is considerable evidence available for this mismatch between the liquidity in the goods and services economy and that in the secondary, non-monetised economy.[6] Real estate prices have increased by 30 per cent (year-on-year) in 2010. There has been a sharp increase in equity prices by about 55 per cent during January through December 2010 with Indian investors and mutual funds exiting markets after profit booking, while FIIs (Foreign Institutional Investors) remain major investors. Prices of agricultural commodities have been

[5] The Coal India Limited (CIL) disinvestment alone fetched US$3 billion.
[6] *Indian Realty News*, http://indianrealtynews.com/category/property-prices. Accessed on 10 January 2011.

shooting up, and there is evidence that the onion price spurts in November and December 2010 were due to stocking of produce by intermediaries; some indications of threat of de-hoarding operations led to prices falling as supplies reached the market. Food price inflation has also been partly due to intervention by commodity traders who have seen this as an opportune investment during inflationary circumstances. These are all cash markets. Real estate deals involve substantial cash transactions, as reluctance to pay property registration charges and capital gains taxes persuades both buyers and sellers to settle for a bulk of the transactions in cash. Indeed, more than 90 per cent of all real estate transactions include large cash components. This is especially true in the smaller towns where there is a surplus of liquidity.

The above effects are exacerbated by other less-discussed but equally powerful influences. The 2009 election is estimated to have cost around US$10 billion on account of substantial cash expenses in arranging for election expenditure as well as for wooing voters. Real estate purchases in several states by people in the political hierarchy as well as those usurping rent from government activities is another source of cash. There is evidence that the size and scale of corruption among politicians and bureaucrats is quite significant. A recent report[7] suggests that India lost an estimated US$213 billion in illegal capital flight. It is possible to argue that a substantial amount would also have been generated as flows within the country from bribery and corruption. Current estimates of the cash economy in India are around 40-45 per cent of GDP, of which the share of agriculture, at around 20 per cent, can be argued to be the legitimate part, the rest being largely illicit cash flows from transactions listed above.

It is therefore possible to argue that with liquidity of close to INR two lakh crores (approximately INR2 trillion) in the economy distorting effects of policies, it would be difficult for fiscal and monetary policy measures to correct the inflationary pressures in the short or even medium term. As long as cash transfers to rural areas continue, and illicit flows augment the black market economy, monetary policy measures are unlikely influence inflation.

Tax to GDP ratios have stagnated and are currently around 7.7 per cent, which is close to 7.6 per cent witnessed in 1990-91.[8] The economy has grown fourfold since the early 1990s and one would have expected that tax compliance measures and reforms in taxation would have improved the ratio to at least 10 per cent. That this has not happened is yet another indicator that the parallel cash economy has been growing at perhaps the same rate as that in GDP, if not faster.

The above arguments indicate that the government would be hard put, through conventional monetary measures, to have any impact on inflation. There is a possibility that an emphasis

[7] Dev Kar, 'The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008', *Global Financial Integrity* (November 2010).

[8] *India Economy Review*, Special Issue (30 September 2010), pp.45.

on greater tax compliance, improvements of institutions and procedures, and even a short term tax amnesty to bring the cash economy into the legal balance sheets, may be a measure that would improve the government's fiscal revenues, while at the same time reining in the free play of the cash economy.

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