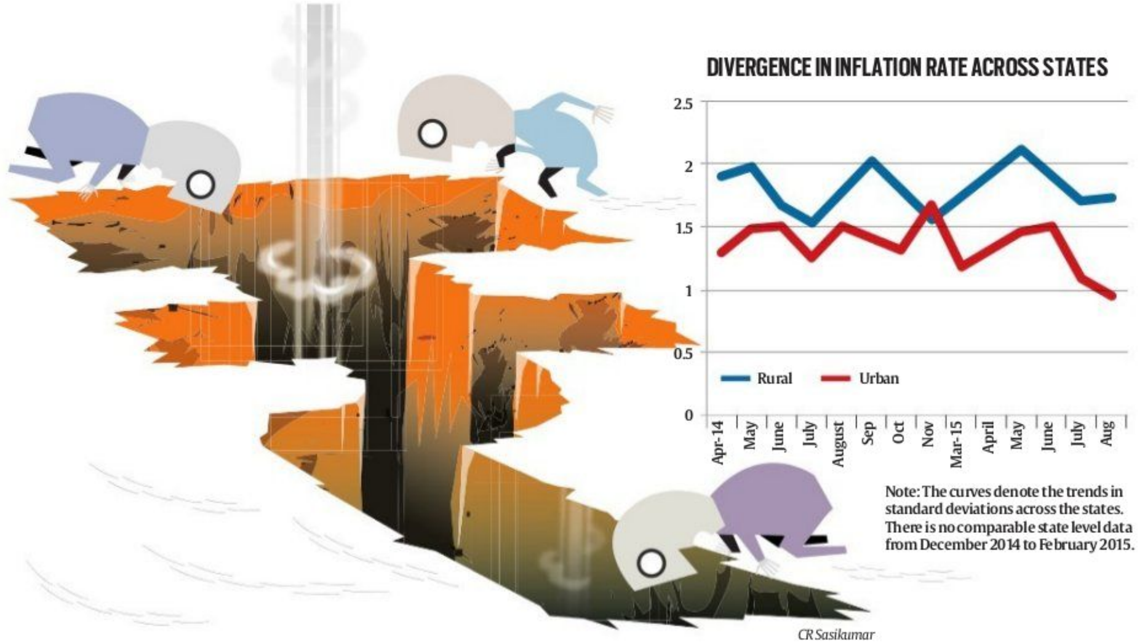
Is India staring at deflation?

India is experiencing disinflation, not deflation. It is time to replace the wholesale price index with a producer price index to avoid further confusion



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THE CHIEF ECONOMIC ADVISOR raised an alarm when he said, "price-wise, the economy appears to be in or close to deflation territory," and this view was based on the GDP deflators estimated through first-quarter GDP data. This is indeed a serious issue at a time when all out efforts are on to revive the investment cycle and growth in the economy. So how serious is the issue of deflation in India?

To begin with, one needs to understand that deflation is nothing but falling prices over two consecutive quarters. In other terms, it is negative inflation. To answer the query about deflation, one would have to look at global prices trends, along with data from both the wholesale price index (WPI) and the consumer price index (CPI).

Based on WPI inflation, one might infer that we are in a deflationary situation because, for the 10th straight month, inflation is in the negative zone. That is, prices have been falling every successive month. For August, WPI inflation stood at minus 4.95 per cent. Indeed, the fall in prices in August took place across all groups in the WPI basket.

But the CPI inflation data tells a different story. As compared to the deflationary trend in the WPI, the CPI is experiencing disinflation. That is, while prices continue to rise, the rate of inflation (or price rise) is slowing. This is contrary to what the trend in the WPI suggests. In essence, it implies that consumer prices continue to rise, but at a progressively slower rate. The combined CPI inflation stood at 3.66 per cent in August. This is much lower than what the RBI has kept as its target for January 2016.

By looking at both these indices one would, at best, be unable to come to a conclusion regarding deflationary pressures. The ongoing confusion about whether or not India is experiencing deflation is largely due to the divergence in these two main price indices of the economy.

With the availability of economy-wide inflation data, CPI numbers have become the nominal anchor for monetary policy in India and are therefore subject to rigorous scrutiny, both by producers as well as users of the data. On the other hand, WPI inflation, which reflects only a segment of the price pressures in the economy — it essentially covers about 40 per cent of economic activity — receives far less scrutiny. Moreover, a significant portion of the prices included in the WPI is still administered by the government.

Under the circumstances, and to avoid confusion, it might be a good idea to discontinue the WPI and focus on a producer price index (PPI). A PPI maps the prices received by domestic producers in the wholesale market and is, as such, a better measure. The work for building a PPI is already underway. So instead of using WPI data and arriving at erroneous estimates of GDP growth and its deflators, it would be better to simply dump the index itself.

Beyond the confusion created by the divergence in CPI and WPI data, there are some interesting observations if one was to look more carefully at the details of CPI numbers. Fortunately, the Central Statistical Office (CSO) has started providing CPI numbers for rural and urban areas. The CSO also provides CPI data for 22 states. This data can provide some regional perspective on inflationary trends for the purpose of macroeconomic policymaking. The graph represents the standard deviations of CPI inflation across the states in rural and urban areas. While they need little deeper analysis, the trends in both rural and urban areas suggest that the divergence in urban areas is less than the divergence in rural areas. This suggests that the decline in inflation in rural areas across the states is less uniform.

Finding answers to why the divergence is more in rural areas could help in resolving the deflation conundrum. To some extent, it may also explain the reduced demand in rural India. Although each one of them needs rigorous empirical verification, some plausible answers could be as follows.

One major reason for higher inflation could be the sharp fall in agricultural activities in most of the states, especially in eastern and southern parts of the country, which are staring at drought-like conditions. While the supply-side impact of a bad monsoon could show up in price levels with a lag, the higher price volatility in rural areas might explain why rural demand has already fallen. Second, undermining of some rural development programmes (such as the MGNREGA) in the recent past, which used to act like automatic stabilisers at the state level, could explain such divergence. Third, it is also important to analyse whether higher devolution of resources from the Centre to the states, from the current year onwards, has contributed to the demand slump in rural areas. Preliminary information suggests that higher devolution to the states has been accompanied by significant cuts in the Central government's budget allocation to some flagship social sector programmes that were mainly for the benefit of the rural population. The cuts in the Central budget were made on the assumption that state governments, with their increased pool of resources, would compensate any shortfall. However, any violation of this assumption could be a major source of the fall in rural demand. Finally, differences in public-expenditure efficiencies and monitoring mechanisms among states as well as local bodies might explain such variations in rural demand. Ambiguity about the Central government allocations under plan transfers, through flagship programmes, could also be hampering the expenditure strategies of state governments and further increasing regional divergences.

> The deceleration in retail inflation could be due to external factors, as well as fall in domestic demand. The ambiguity surrounding the Centre-state expenditure strategies post the 14th Finance Commission recommendations could be a crucial determinant of the reduced demand. The more alarming bit is the volatility in rural inflation, which needs special focus. Monetary policy, while focusing on the headline and sectoral prices, also needs to take into consideration the regional inflation perspective.

To sum up, while India may appear to be far from a deflationary situation, there is clearly disinflation in the economy. This deceleration in inflation could be due to external factors as well as a fall in domestic demand. The ambiguity surrounding the Centre-state expenditure strategies post the 14th Finance Commission recommendations could be a crucial determinant of the reduced demand. The more alarming bit is the volatility in rural inflation, which needs a special focus. Monetary policy, while focusing on the headline and sectoral prices, also needs to take into consideration the regional inflation perspective. For their part, both the Centre and the states should work to ensure that rural consumption smoothens. Else, growth in India might take much longer to recover.

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