Quickonomics

November 13, 2020

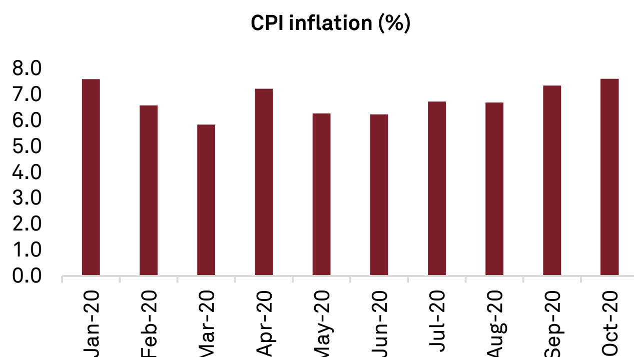
Counterintuitive inflation

The Reserve Bank of India (RBI)'s inflation targeting is, in ways, embedded in the Phillips curve framework, which supposes an inverse relationship between unemployment and inflation in the short run – implying economic growth pushes up inflation and pulls down unemployment, and vice versa.

In fact, this is what lends intuitive support to a counter-cyclical monetary policy to stabilise inflation.

But India's headline retail inflation, or inflation based on the consumer price index (CPI), has defied this relationship of late. CPI inflation printed at 7.6% for October, the highest in more than six years, even though the economy is faced with large-scale losses.

Headline retail inflation heating up



Source: MoSPI

A recession-inflation situation such as this is highly undesirable and becomes a policy nightmare. Here's why.

Acts as a brake on the rate easing cycle

Headline CPI inflation has remained above the upper end of the RBI's target band of 2-6% for seven straight months now. On average, it has been outside the band for more than three consecutive quarters. Given its inflation targeting mandate, the Monetary Policy Committee (MPC) had little option but to halt its rate easing cycle (repo rate has stayed at 4% since May 22) prematurely, even as there was space for lowering policy rates further.

Hinders the Centre's borrowing plan

The government has kept its market borrowing plan (of Rs 12 lakh crore[1] for fiscal 2021) unchanged, as opposed to the expectation that it would be enhanced to allow greater fiscal stimulus. One reason for this could be its generally conservative fiscal stance. But another could be its attempt to assuage the long-term borrowing yields, which remained stubborn despite a large cut in the policy rate and the RBI's 'operation twist' programs.

A halt in repo cut by the RBI in the face of high inflation only buttressed the upward pressure on yields.

That said, extraordinary support from the RBI and its statement that the MPC would look through inflation and maintain an accommodative stance through the next fiscal, has helped soften yields of late.

Lowers real G-sec yields

Real yields not only reflect the true gains (inflation adjusted) for domestic bond investors, but also influence foreign investors looking to benefit from high real yields by investing in emerging market local-currency debt[2].

This is because currencies associated with high real yield economies are generally expected to perform better, and hence, give benefits of appreciation to foreign investors.

In this context, the decline in real 10-year government security (G-sec) yield, i.e. nominal yield adjusted for expected inflation,[3] reduces the attractiveness of Indian government debt, especially when compared with some other emerging market peers.

Real G-sec yield is now below 2%, down from ~4% in the beginning of last fiscal (see chart below). On average, it stood at 1.8% during April-October, compared with ~3% in the year-ago period. No wonder, foreign portfolio investments in debt is tepid compared with equities[4].

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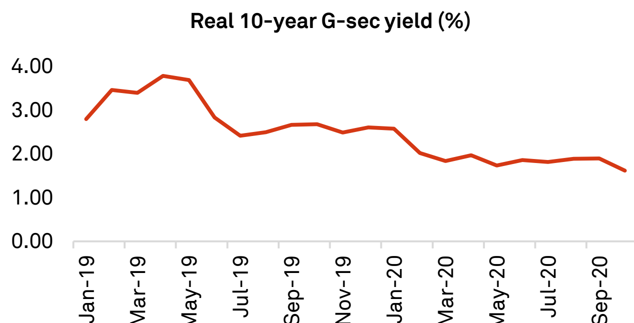
[1]In addition, the Centre later decided to borrow Rs 1.1 lakh crore more specifically for compensating states' GST shortfall
[2]Foreign investment in local currency bonds – Considerations for emerging market public debt managers, World Bank, December 2012
[3]We have used mean forecast of professional forecasters 1-year ahead inflation expectation
[4]Refer to our note 'Yielding to fundamentals? More of a toss-up', November 02, 2020

Real 10-year yields have come down



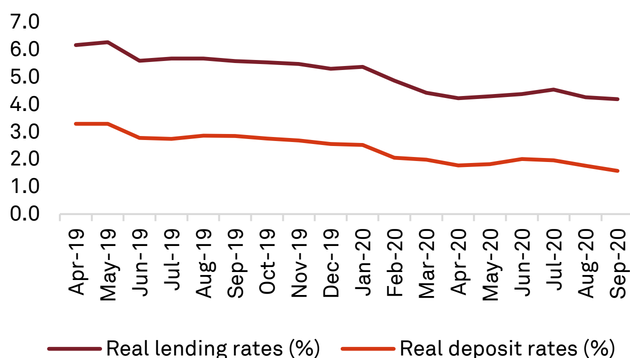
Source: MoSPI, RBI, CRISIL

Results in disincentive for saving

Nominal interest rates – both lending[5] and deposit[6] – have declined on account of the RBI's rate easing cycle since last year. High inflation, at the same time, has meant that real interest rates are even lower.

While households currently continue to put money in banks due to increased proclivity to save, they are getting penalised as real deposit rates are extremely low. What happens to those aged and pensioners who have little option but to keep their money in banks?

Double whammy of low real interest rates



Source: RBI, CRISIL

For borrowers, on the other hand, this would be a good thing. However, given the current uncertain environment, there is hardly any appetite for debt from the corporate sector and banks too are wary of lending.

Dampens consumption further

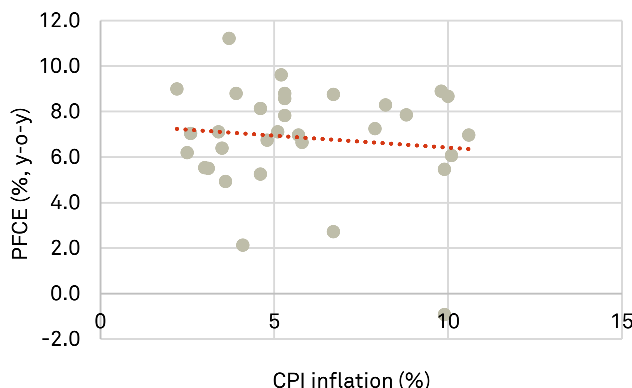
High inflation reduces disposable income as people are required to pay more to buy the same set of goods and services. Given that consumption is so critical for revival of Indian economy (with ~55% share in the GDP) and that the pandemic has resulted in job losses and income destruction, high inflation is the last thing households want.

The following simulation puts this in context.

In fiscal 2020, private final consumption expenditure (PFCE) stood at Rs 123 lakh crore (in nominal terms). If we assume retail inflation goes up by 1 percentage point, overall private final consumption expenditure increases by Rs 1.23 lakh crore to consume the same basket of goods and services. Similarly, one percentage point increase in food inflation pushes up the food bill by ~Rs 0.33 lakh crore.

Empirical evidence (see chart below) suggests a weak negative relationship between inflation and consumption expenditure. Which means, given their budget/income constraint, households tend to slow down consumption of non-essentials when prices rise fast. The current scenario of income loss and higher inflation, therefore, does not augur well for sustained consumption revival in the economy. Consumption spend this year is already suppressed, particularly in the services sector, given pandemic related anxieties and income hit.

Quarterly relationship between PFCE and inflation (since fiscal 2012)



Source: MoSPI, CRISIL

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[5]*Weighted average lending rate on fresh rupee loans*
[6]*Weighted average term deposit rates*

Conclusion

To reiterate, high inflation and low growth spells trouble for policymakers and residents, alike. India is one of the rare inflation-targeting countries that seems to be facing such a challenge at the moment.

What complicates the situation further is that, other than food, which is the biggest contributor to the elevated headline inflation, core inflation – a better gauge of underlying inflationary pressures in the economy – has also remained stubborn despite economic contraction. This is because of higher bullion, transport and communication prices.

While it is hoped that inflationary pressures may subside as fresh kharif output hits the market and supply disruptions ease, any rate cut can be expected only when there is a discernible clamp down in inflation.

CRISIL revised its CPI inflation forecast for fiscal 2021 to 5.6% in October, 1.6 percentage points higher than its first forecast in February and will be monitoring the developments closely.

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