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India's inflation dilemma during the pandemic

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As is well known, the COVID-19 pandemic induced disruptions and economic crisis in 2020 has been unprecedent. The global pandemic has disordered the market forces of demand and supply in many countries. While the demand-side disruptions are due to the subdued economic activities, the supply shock is due to the persistence of inflation and its associated effects. Prices and inflation during the pandemic period remained high and became a matter of concern not only in the advanced economies, but also with most of the Emerging Markets and Developing Economies, including India.

Against this backdrop, it is vital to raise India's concern over prices and inflation. In fact, the Government of India's Economic Survey 2020-21 made some interesting observations in this regard. The Survey pointed out that, in India, the headline CPI Inflation-Combined (CPI-C) was on a downward path till 2017-18, followed by rising trend in the subsequent years. Though the effect has softened in recent months, it remained high during the pandemic period (Apr-Dec 2021). Further, the increase in CPI-C during the pandemic year was mainly driven by an upsurge in food inflation, particularly vegetable prices; while the core inflation (i.e., inflation in the price index excluding food, fuel, and other volatile components) except housing shows a rising trend mainly due to the disruptions in services and volatility in gold and silver prices. As far as the rural and urban difference in the CPI inflation is concerned, CPI-Urban has moved closely with CPI-Rural during the period. Though convergence is almost observed in the case of food inflation, the non-food components of CPI are lower in rural areas as compared to urban areas.

Another important observation of the survey is that inflation trends are usually observed using a twelve-month change in the index. The rationale behind observing the year on year (YoY) change in inflation is that it will eliminate the seasonal fluctuations. However, the major challenge in using the YoY change in inflation is that it does not distinguish between recent price changes and price changes before a year. This signifies the role of the base and momentum effects. While base effect accounts for inflation changes due to the abnormal changes in CPI in the base month, the momentum effect considers changes in inflation caused by price changes in the current month. Therefore, it is necessary to distinguish the existing trends of inflation between base effect and momentum effect. The difference between the YoY inflation rates in two subsequent months is almost the same as the difference between the month-on-month rate in the current month and the month-on-month rate in the base month.

A higher momentum effect or lower base effect has a positive impact on the changes in inflation. While the rising trends in headline CPI and Core CPI during the pandemic period, except in November and December, were driven by momentum effect, it was significantly moderated by the base effect. In November, the price momentum was coupled with a positive base effect. Though a very similar pattern was observed for the food and beverages component of CPI-C as in non-food and non-fuel components, slightly different patterns emerged among various subgroups under food and beverages. Whereas price momentum has dominated in the case of oil and fats and vegetables, negative price momentum was observed in the case of cereals, meat and fish. Among the miscellaneous category, the increase in the inflation of 'transport and communication' and 'personal care and effect' were mostly driven by a substantial jump in the price momentum. These mixed observations demand further crop-specific and time-specific exploration in this regard.

As indicated, the primary driver of CPI-C inflation in the pandemic year (April-December) was the food and beverages group (almost 60 percent), similar to that in the previous years, followed by miscellaneous group and housing. Food inflation is computed based on the Consumer Food Price Index (CFPI), comprising ten food groups. It remained high during the period is indicative of Covid-19 induced supply chain bottlenecks, particularly in the case of 'vegetables', 'meat & fish', 'oils & fats', and 'pulses & products. Interestingly, the vegetable inflation was mainly on account of a rise in prices of potatoes and onions. Another important fact is that the production of pulse varieties during the year was not as expected. In the case of shortfalls in domestic supply, import policy is much warranted to ensure the availability and moderate prices. However, the pandemic year registered confusion among market participants due to frequent changes in import policy. As a result, the import was highly negatively correlated with production.

The survey made some observations on the novel concept of a thali price in the Chapter titled "Thalinomics": The economics of a plate of food in India. It postulates the Thali cost, which represents the cost of a meal cooked within household and the Thali index, compiled by the NSO as per the Consumption Expenditure Survey 68th Round data (2011-12) for CPI-C. The cost of both vegetarian and non-vegetarian thalis has increased steadily during the pandemic period (April-December), except in December. However, it displayed much variation among the states/UTs. Though there were significant variations among states on thali prices during the period, researchers doubt whether it has a true representation of the consumption pattern of an average Indian.

CPI-C inflation increased in most of the states during the pandemic year. Though the regional variation persists between states/UTs with Lakshadweep at the top and Delhi at the bottom, inflation was below the all-India average in 17 states during the period. Interestingly, most states/UTs have witnessed higher urban inflation than rural inflation, with some variations because of the high food inflation in urban areas. In particular, the majority of the East and North Eastern states experienced relatively higher inflation in rural as well as urban areas. Among the major contributors of overall CPI inflation as per weights, Maharashtra occupies the top position, followed by Utter Pradesh, West Bengal and Tamil Nadu. With respect to the 'thali', Andaman & Nicobar Islands has the most expensive veg thali in both rural and urban areas. While North Eastern states registered the most expensive non-veg thali in both rural and urban areas, while rural and urban areas, north and central India registers at the bottom line comparatively with some exceptions.

Another important query raised by the Survey is, which measure of inflation reflected economic activity better in 2020-21? Here it made a comparison between CPI-C, Core CPI, and WPI inflation. In fact, WPI inflation remained benign during the pandemic period. Food items have a large weightage in the CPI-C index, implying that shocks to food prices could have large impacts on CPI-C inflation, which is in sync with the economy's demand conditions. However, it is weakly related to Index of Industrial Production (IIP) growth. While WPI inflation and CPI-C, core inflation are positively and strongly associated with IIP growth, reflecting production.

A tight monetary policy could easily manage demand-pull inflation. But the pandemic scenario was mainly a supply-side phenomenon. Therefore, policy action must be redesigned by smoothening the supply chains, redesigning the outdated weight structure in the construction of the price index, incorporating retail e-commerce transactions to construct price indices, etc. Further, researchers have no consensus whether headline inflation targeting or core inflation targeting is welfare improving. Fortunately, core inflation is often considered as a better measure of inflation for monetary policy purposes because food and fuel inflation are transitory, supply-driven, and non-monetary. Inflation targeting could also help anchor inflation expectations. While CPI inflation remained close to the upper threshold of the monetary policy target of 6 percent, the one year ahead expected CPI-C inflation has also risen.

Realizing the existing issues concerning the prices and inflation, there was a call for long-term strategic measures such as consistency in import policy on pulses and edible oils, review of the onion buffer stock policy, curtail the uncertainties in the gold prices, development of a wastage reduction system, decentralised cold storage facilities at production centres, judicious use of fertilizers, timely irrigation and post-harvest technology, etc. in order to control the inflation. Also, it is already expected that some food and non-food prices will continue to soar for at least in the next few months. The Union government's policy intervention is much warranted for the prices of those items beyond the states' control. The expectation was huge on the government's budget for 2021 in this regard. However, the budget didn't give enough attention to tackle this issue. Not much concern is evident in any of the current budget documents even after CPI inflation is close to the monetary policy target of 6 percent during the pandemic. It stipulates that inflation will remain a buzzword for some time to come.