India’s Q1 GDP may shrink up to 21%; why RBI should look at wholesale prices more than retail inflation

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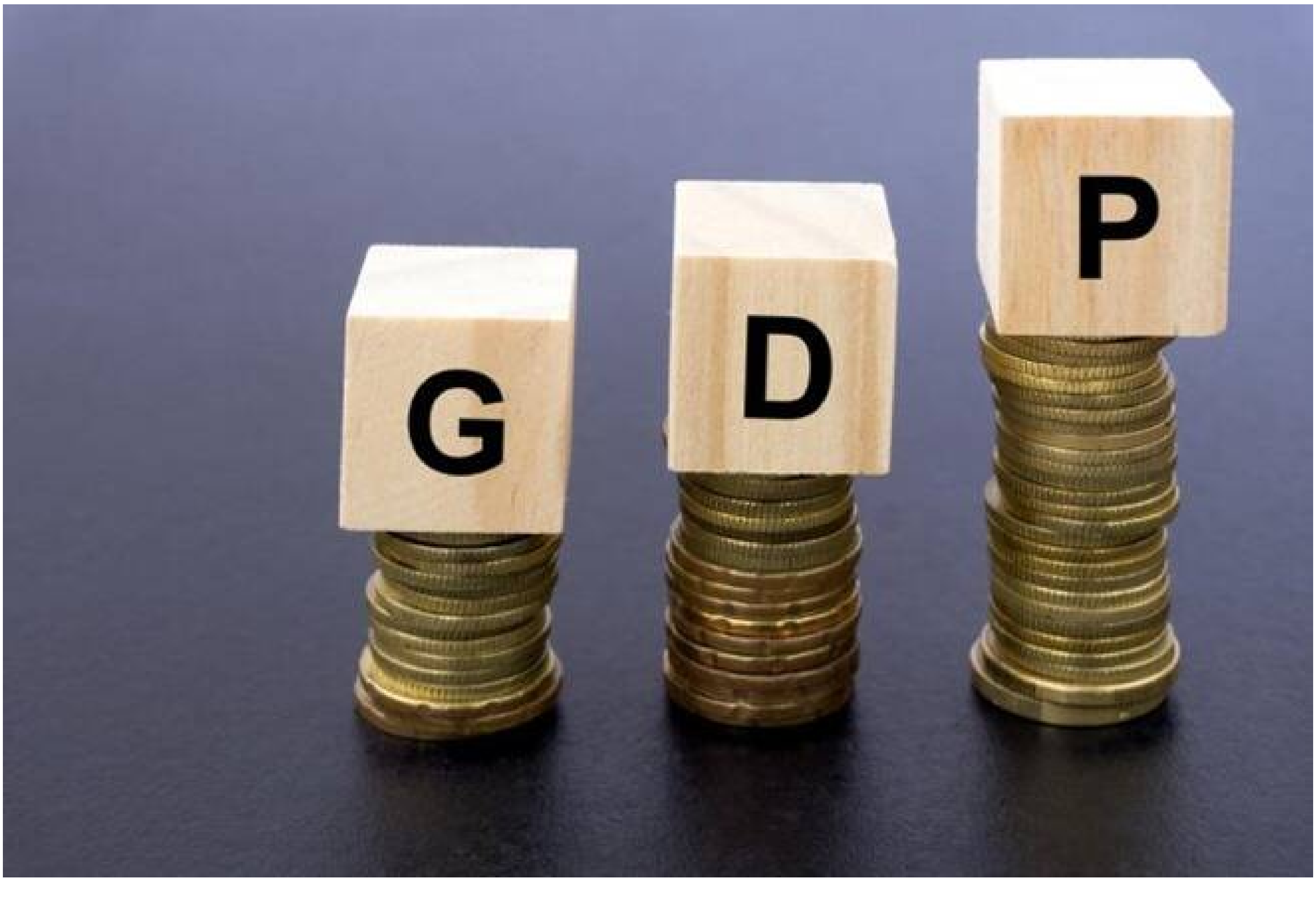

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In the backdrop of rising inflationary numbers and a grim economic perspective, the Reserve Bank of India (RBI) in its Monetary Policy Committee (MPC) meeting on August 4-6, 2020 decided to leave the repo rate and reverse repo rate unchanged at 4% and 3.35% respectively. The RBI maintained that its stance on the monetary policy was ‘accommodative’ as has been even prior to the pandemic. With the Covid19 resulting in demand and supply chain disruptions and brusquely bringing the Indian economy to a halt, the regulatory body’s response had been of reducing repo rate by 115 basis points since February with a viewpoint of enhancing liquidity to the tune of approx. Rs. 1,37,000 crore.

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The decision to keep repo and reverse repo rate unchanged has been in light of retail inflation showing an upward trajectory and touching a high of 6.93% in July 2020. On the flip side with experts predicting a contraction for the Indian economy of anywhere between 14% to 21% in Q1 of 2020 should RBI focus on inflation or economic growth?

In March 2016, RBI had formally adopted the mandate of flexible inflation targeting framework and agreed to maintain inflation numbers around 4% with a band of (+/-)2%. The first Monetary Policy Committee has been judiciously achieving its target for a considerably large part of its tenure in office. The six member committee has managed to maintain inflation within the target band of 2-6% for most of the time however, the record has been tarnished by consumer price growth being well above the range towards the end of its tenure with CPI numbers at 6.93% in July 2020.

At this point of time due to the ‘Black Swan’ event created by the pandemic, should the RBI not additionally analyse and assimilate information on indices such as consumer food price inflation, core inflation, wholesale price index, and GDP numbers and thereafter strategise for the well-being of the economy?

Economic Outlook based on other indices

An in-depth analysis of the upward trend in the Consumer Price index portrays that higher prices of food articles have contributed to the increased elevation. The Consumer Price Index YoY for June 2020 was at 6.09% while Consumer Food Price India YoY June 2020 was at 7.9%. Rather, the Consumer Food Price Index in July 2020 surged to a high of 9.62%.

and vegetables. But, the other side of the coin shows that the benefit of increased food prices has not actually reached the farmers. We still read stories of farmers dumping their products as they are not able to recover their cost of production. It would only be right to state that increased food prices are on account of supply chain disruptions caused by localised and regional lockdowns.

Better monsoon, easing of lockdown and the three ordinances approved in June 2020 under the APMC Act, Essential Commodities Act 1955 and Farmers (Empowerment and Protection) Agreement on Price Assurance and Farm Services Ordinance, will help reduce food inflation and thereby bring CPI within RBI's target of 2-6%. At this juncture, it is needed that the Central and State Governments should work towards improving and stabilising the supply chain and ensuring a quick and efficient flow of food, vegetables, pulses, fruits etc. from the farms to the mandis to the retailers. The panacea required for an increase in food prices is not an intervention by the RBI but the Government ensuring a smooth and efficient supply chain solution for farmers, retailers and consumers.

Another index which shows that the status quo strategy of RBI can be further deliberated upon are the Core CPI numbers. On deep diving into CPI and Core CPI numbers, data shows that while CPI YoY for Q1 2020 is at 6.6%, core CPI YoY for Q1 2020 is at 4%. Core CPI is an inflation index that excludes temporary price volatility in terms of food and fuel. Core inflation is estimated to arrive at the actual inflation excluding the effects of temporary shocks and volatility. While CPI is above the 2-6% band, core inflation for Q1 2020 is still very much within the limits and is at approx. 4%.

Last but not the least, importantly, RBI should look at the story being told by the Wholesale Price Index (WPI). WPI is the index measuring the prices of a basket of goods at the point of sale of wholesalers. It measures the price changes of goods sold and traded by wholesale businesses ie at the factory gate prior to the retail level. This helps track the supply and demand in industry, manufacturing and construction primarily.

The picture painted by WPI shows that inflation at the wholesalers' point stands at (-) 0.58% even as Consumer Food Price index surges upward. This was largely on account of the reduction in global crude oil prices and demand for non-essential items sharply declining. The WPI deflation is reflective of a decrease in discretionary spending by consumers and an indicator to producers of a slowdown or recessionary trend in the economy.

With the lockdown resulting in demand and supply chain disruptions, there was a considerable decline in consumption. Manufactured products constitute 64% in WPI and with the lockdown bringing the economy to a halt, it has significantly contributed to the overall deflation in WPI. Weak demand for non-essential items is reflective of a fall in the production of industrial goods. WPI inflation is indicative of a steep decline in consumer demand and is an early warning of recessionary trends appearing in the Indian economy.

Economists have opined that recovery of the Indian economy might take sometime while coronavirus cases are on the rise and the pandemic has spread to the rural areas and other interiors of the country. National Council of Applied Economic Research (NCAER) has pegged Q1 at (-) 25.7% contraction while Nomura has estimated a contraction of (-)15.2% in Q1 2020. This is indicative of declining business confidence, people losing jobs, less income available to spend and negative consumer sentiments.

pandemic and industrial production, manufacturing and services have shrunk ie (-)35.9%, (-)40.7% and (-)35% in Q1. A comprehensive fiscal and monetary policy is needed which can further restore and reinforce the business confidence of producers.

Yes, with Unlock1.0 pent-up demand resulted in buoyed consumer sentiments initially and showed green shoots of economic recovery but it is imperative that in an unprecedented situation both the Government and RBI should primarily focus on and work consistently towards reviving economic growth. Economic growth / recovery will fuel production leading to increased jobs resulting in increased income and purchasing power in the hands of the people. Only with increased income and purchasing power and control of the pandemic will there be a revival of demand for non-essential items and a rise in discretionary spending. Thus, at this point of time RBI should be focusing on the revival of economic growth and economic recovery and not at inflation as its primary focus.

As an exception, RBI should make monetary policy decisions based on WPI numbers as against CPI numbers and should aim for economic recovery at the earliest. Further rate cuts will increase business confidence and support consumer sentiments fuelling up demand in the economy. However, we should not forget that this can happen only when jobs of people are intact and they have income in their hands. Yes, we agree that an eye should be kept on food inflation, but the same can be controlled by ensuring that supply chain disruptions are minimised and efficient and quick flow of fruits, vegetables, pulses etc. is maintained from the farm to the fork.

Thus, in our perspective with the prediction of the contraction for the Indian economy being anywhere between 14% to 21% in Q1 of 2020, the RBI should look at WPI along with economic recovery as its main objective while deciding on policy recommendations and not at CPI numbers. After all, an unprecedented situation calls for out of the box thinking and out of line strategies. While respecting the autonomy of the monetary authority it is expected from RBI that it would stand up to the extraordinary economic crisis in terms of policy response.

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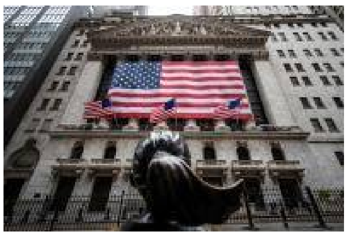

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