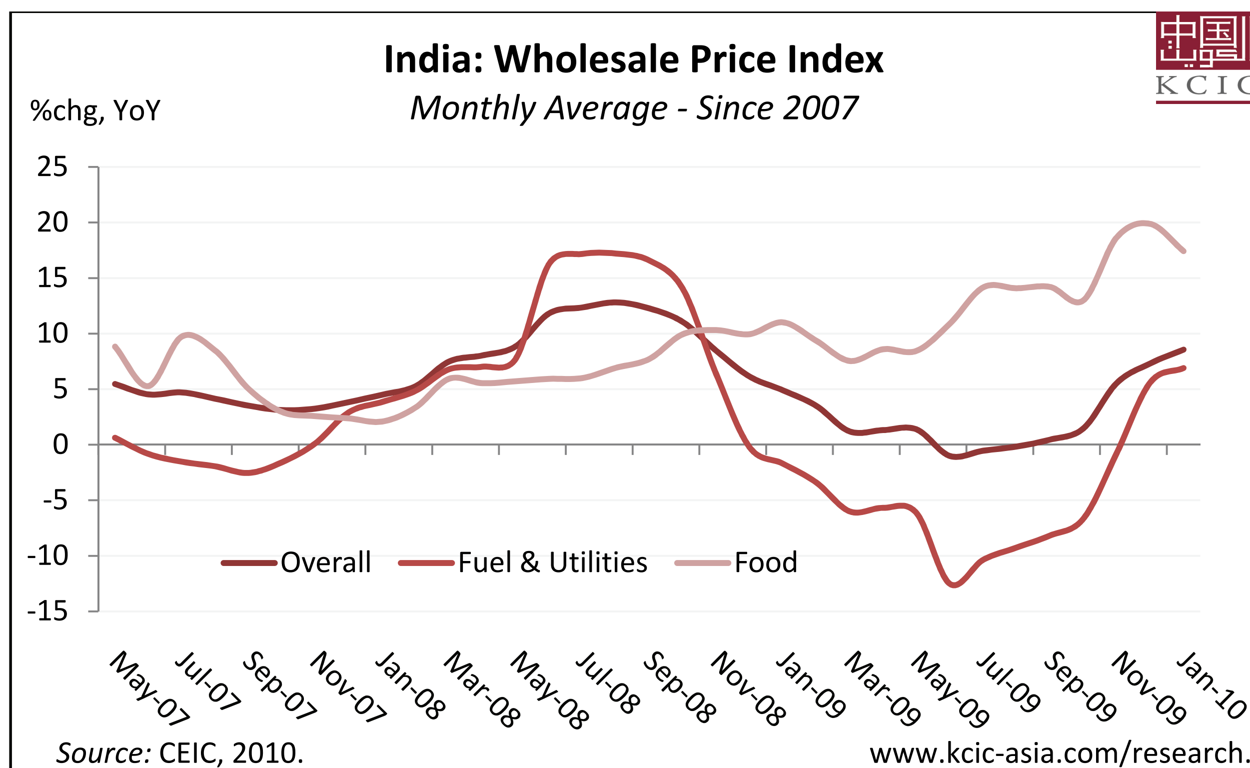
Looming Inflation Risks in India



Why is this graph important?

As economic activity improves in India, the *Wholesale Price Index* (WPI) is picking up - bringing about a risk for the Indian economy, inflation. The above graph plots the Indian WPI, a commonly used indicator to assess domestic inflation, along with its energy and food components. Inflation is often due to overheating and the lack of price stability is deemed troublesome for any economy. As inflation comes close to 10%, the Reserve Bank of India (RBI, the Central Bank) may have to hike up interest rates at the risk of slowing the growth in the economy.

What does the indicator tell us?

The *Wholesale Price Index* (WPI) measures the change in the average price level of goods traded in the Indian wholesale markets. The index is composed by a basket of a weighted average of a total of 435 commodity prices, and, as of November 2009, the government releases WPI data on a monthly basis, instead of every week. This change in frequency, however, does not alter the relevance of the WPI. The data points in the figure above are the year over year change in the monthly average of the WPI and its food and energy components.

The WPI focuses on prices of goods traded in bulk. It is widely used by the government and by business and industry circles as a reliable indicator of the inflation rate in the economy. The index movements reflect the supply and demand dynamics in the industrial, manufacturing, and construction industry. The

WPI is used for forecasting variations in the business environment, measuring changes in the purchasing power of money, and monitoring the effects on the exchange rate.

Since the end of 2007, India experienced a substantial rise in the WPI, which persisted until the onset of the financial crisis, in the third quarter of 2008. This rise was largely due to the strong growth of the Indian economy, brought about by massive investments in almost every sector, and to the ensuing rise in personal income levels. At the end of 2008, the world economic crisis caused a liquidity crunch across the globe, which in turn caused a slowdown in the Indian economy, and eventually lead to a decline in the WPI. As a response to the crisis, the Indian government eased its monetary policy to help businesses and to boost growth. The liquidity pumped into the domestic economy lead to another rise in the WPI, which started in September 2009 and is now approaching double digit levels.

What are the economic and financial implications?

The government is closely monitoring the WPI and has indicated that it is a priority to ensure the availability of essential commodities at adequate prices. To absorb some of the liquidity in the market, the RBI raised the cash reserve ratio, a ratio set by the central bank measuring the required amount of reserves to consumer deposits that banks must hold. The RBI has not raised the interest rates from 3.25% since the crisis, and WPI has continued to grow and is now - as of January 2010 - at 8.56% year over year. The food component of the price index has declined since the high of 20% at the end of 2009, but it is still gowing at the fast rate of 13.5% year over year. This is due to the supply constraints caused by the worst drought the country has ever faced since 1972. The other worrying factor is the effect of energy prices on the WPI; the fuel commodities are mostly imported, bringing inflation into prices, a factor that the Indian government cannot control. The RBI will meet on the 20th April and their decision will be closely monitored. The expectations are that rates will be raised to curb this rise in prices.

In the presence of rising inflation, investors tend to invest in either inflation-linked government bonds - which shield investors from the adverse effects of inflation - or stocks of companies not adversely affected by rising prices. Such companies are able to pass the cost of inflation on to their consumers. But in time the continued rise in food prices and the spike in energy prices will likely pass on to the manufacturing sector.

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