Press Release

Stagflation risks on the horizon

Persistence of CPI beyond 6% may lead to rise in interest rates

19 August, 2020

Acuité Ratings believes that the risks of stagflation have increased significantly for the Indian economy which may slow down the effectiveness of monetary and fiscal measures adopted by the central bank and government. Stagflation implies a painful phase of high inflation but low or negative growth which can aggravate the challenges faced by the Indian policy makers. The uncertain outlook on inflation in the short term has already led the MPC to hold the interest rates in August and has also diminished the likelihood of any further rate cut in the near term. In our opinion, immediate steps need to be taken to bring down food inflation, the higher levels of which have already started to spill over to core inflation.

India's consumer inflation has increased to 6.93% in July 2020, a bit sharp and unexpected rise of 70bps (MoM) over that in June; since December 2019, CPI print has been on an overdrive and has been uncomfortably high over 6.0%, the upper limit set by the monetary policy committee (MPC). Even though an unfavourable base effect is also playing an important role in shaping the inflation trendline, food inflation (CFPI) has been the primary driver of the CPI trajectory and has mostly hovered over 8.0% over the last nine months since October 2019. The supply and logistical bottlenecks arising from the prolonged and intermittent lockdown in certain parts of the country have continued to keep food inflation high despite a good agricultural output over the last two seasons. The animal protein segment i.e. meat, fish, eggs and milk, edible oil, vegetables and pulses have seen double digit inflation in July; limited operations of APMCs in the lockdown period, import challenges along with excess rains or floods have all led to a disruption in the supply chain of agricultural products.

Further, persisting high food inflation along with shortage of labour have started to have a rub-off effect on prices of non-food products and services or core inflation; which has risen by 50 bps to 5.6% in July 2020 from 5.1% in June 2020 and 4.1% in last July. Higher core inflation is reflective of cost push pressures and higher money supply in the economy despite the weaker demand environment. Our analysis indicates that there are two major components of higher core inflation –transport and communication as well as personal care products. While global crude prices have sharply dropped by 33% from USD 62.5 a barrel (July 2019) to USD 42.1 a barrel (July 2020) over the last one year, the cost of transport and communication services have spiked by 9.95%, reflecting the impact of sharply higher excise duties on fuel imposed by the government to bridge the revenue shortfall over the last few months. Further, telecom tariffs have also seen a rise of 15.3% triggered by the consolidation in the industry. Lastly but not the least, the 45% yoy surge in prices of gold, an important item in the purchase basket of Indian households has also been an additional factor in building inflationary pressures.

While weak demand and a low growth environment should slow down inflation, it has been seen globally that a high level of monetary and fiscal stimulus in response to a persistent poor growth scenario, may at times, increase the money supply and push up inflation while not addressing the growth problem effectively. The current domestic economic scenario is characterised by output contraction along with increased inflation and higher money supply. We note that the growth in broad money supply (M3) has been at 12.7% yoy at July end as compared to 10.1% a year ago; importantly, the currency with public has grown sharply at 23.6% yoy and may have also been a factor in the relentless inflationary pressures.

Going by the MPC's mandate on inflation targets, RBI may have to cast off its accommodative stance and adopt a tight monetary policy, if the inflationary pressures don't subside over the near term. The consequent reversal of lower interest rates will raise capital costs and impact the outlook towards new investments, complicating the growth and the unemployment problem further. Clearly, the risks of a stagflationary environment has increased in the case of India and may be a socio-economic challenge if not addressed early.

In our opinion, monetary stimulus programmes will have a limited impact in reviving growth in such an environment and targeted fiscal measures will have to be considered to pull up private consumption as the pandemic scare eases out over the next few months. It will have to be a fine balancing act between the central bank and the government with fiscal programmes to be administered before any change in the accommodative monetary stance by RBI. Lastly, the government also needs to take proactive steps to control food inflation by reducing supply bottlenecks and adopting appropriate policy measures in the short term as also facilitating the proposed agricultural marketing reforms and agriculture infrastructure development over the medium term.

About Acuité Ratings & Research Limited:

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