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INFLATION OUTLOOK - 2006/07

WPI Inflation - Trend During 2006/07

1. The annual rate of WPI inflation has continued to rise in the course of the past several months peaking on a year-on-year basis to 5.45% for the week ending 18 November 2006. On a cumulative basis for fiscal 2006/07, the WPI inflation is now 5.9% (provisional), higher than in the previous two years (Table 1). Actual inflation may in fact have been higher if the provisional value of the WPI index is adjusted upwards as has been the case recently.

Table 1
Cumulative WPI Inflation (and major components)
(During the fiscal year up to week ending November 18, 2006)

	WPI (all)	Manufactured goods	Energy incl. petro products	Primary Food	Foodgrain	Primary food other than Foodgrain
2004/05	**5.3%**	3.5%	10.2%	6.8%	2.1%	9.0%
2005/06	**4.5%**	1.8%	7.5%	9.6%	5.3%	11.6%
2006/07 (prov)	**5.9%**	4.9%	4.1%	10.7%	8.8%	11.5%

Note: The WPI data for 18 November 2006 is provisional. In the most recent 4-week period for which data is available (up to 23 Sept. 2006), the revised data reported inflation that was 0.55 percentage points higher than the provisional data. For the most recent 8-week period, the upward revision was 0.32 percentage points. Thus, it is probable that the actual rate of inflation on a cumulative basis for the fiscal year for the week ending 18 November 2006 was over 6.0%

2. There are three points to note on the inflation trends: (i) the significantly higher rate of inflation this year is stemming from primary foods and manufactured goods; (ii) inflation in primary food items is outpacing that in manufactured goods by a big margin for the third year in a row; and (iii) the price pressure from energy during this fiscal year is much lower than it has been in either of the previous two years.

WPI Inflation - Disaggregated Picture

3. The disaggregated picture of overall WPI inflation is summarized in Table 2. Column (3) shows the contribution of the product category to overall WPI inflation in percentage points of inflation while column (4) shows the reported year-on-year inflation for the week ending 18 November 2006.

Table 2
Contribution to WPI Inflation (year-on-year)
For the week ending 18 November 2006

Item	Weight	Contribution to overall WPI inflation	Year-on-year inflation rate
(1)	(2)	(3)	(4)
Overall WPI inflation	**100.00**	**5.45**	**5.45%**
Primary Articles	**22.03**	**1.56**	**7.1%**
Primary foods	15.40	1.18	7.7%
Foodgrain	**5.01**	**0.64**	**12.9%**
Other primary food	10.39	0.56	5.4%
Other non-food primary	2.60	0.23	8.8%
Commercial Energy	14.23	0.78	5.5%
Petroleum products	6.99	0.43	6.1%
Manufactured Goods	**63.75**	**3.04**	**4.80%**
Dairy products	0.69	0.05	6.6%
Grain mill products	**1.03**	**0.19**	**18.50%**
Edible oil	2.76	0.22	7.9%
Cotton textiles	4.22	0.25	5.9%
Paper & paper products	2.04	0.18	8.8%
Rubber, plastics etc	2.39	0.19	7.8%
Non-metallic minerals	**2.52**	**0.36**	**14.4%**
Non-ferrous metals	**1.47**	**0.55**	**37.6%**
Machinery & machine tools	8.36	0.53	6.3%

4. The product categories with inflation rates significantly above the average and with relatively large weights in the WPI basket have been highlighted to underscore their contribution to overall inflation

WPI Inflation – Looking Ahead to End 2006/07

Foodgrains

5. The 8.8% increase in foodgrain prices on the aggregate during the current fiscal masks the fact that the prices of wheat and pulses have risen by an enormous quantum, which has been partially offset by a slower pace of increase in rice (paddy) price, which also has a much larger weight in the WPI basket. The increase in price of wheat in the course of fiscal 2006/07 has been 10.0%, that of pulses 21.1%, and rice 4.5%. Last year, rice price had declined through the winter, and as a result, the inflation rate on cumulative basis for rice which was 4.0% for the week ending 19 November 2005 had declined to 2.7% by the end of the year. The trend in wheat had been precisely the reverse: the cumulative increase through the course of the fiscal year was 2.8% up to 19 Nov 2005, but prices continued to rise and the year closed at 12.9%.

6. The increase in prices of wheat and pulses had continued after the policy measures adopted in June 2006. In comparison to the price level at the end of June 2006, price of wheat is higher by 15.3%, that of pulses by 12.0% and of rice by 2.9%. In the case of the latter, if the trends evident in earlier years were to recur – that is a softening beginning mid-/late-November – there will be some relief on inflationary pressure on foodgrain as a result.

7. However, with the reported lower harvest in Australia and the overall strength of demand vis-à-vis supply and low stock positions the world over, global wheat prices have continued to rise. Wheat demand is expected to rise, while world production is expected to decline further in 2006/07, as a result of which global stocks, already at historically low levels, may fall further by 20%. International prices of wheat (and products thereof such as flour) have been steadily rising in the recent months. US price of wheat has risen by 9% between June and October 2006, and by 5% between July and October 2006[1]. Projections of output for 2006/07 seem to suggest that there will be a further significant decline of world wheat production, leading to the lowest stock position in over a quarter of a century and presumably further upward pressure on prices. These global trends have put upward pressure on domestic price of wheat and will continue to do so. The position with respect to rice is however expected to be more comfortable.

[1] Prices quoted by USDA, for #2 HRW fob Gulf – *Wheat Outlook*, 14 Nov 2006.

8. This situation may alter significantly if our rabi wheat output is stronger than seems to be widely expected. India is the second largest producer of wheat (after China) and what happens with our harvest is likely to have both local and global implications. The wheat output last year was 69.5 mt (million tonnes), but is likely to be revised down to 68.0 mt). This was marginally higher than that in the previous year and much lower than the 72.2 mt of 2003/04 and 76.4 mt of 1999/2000. If as has been reported, higher wheat prices have encouraged more planting of wheat, and if as a result, this year's output is several million tonnes higher than that of the previous year, there would be some relief on the upward pressure on domestic wheat and grain mill product prices.

Petroleum Product Prices

9. The impact of the reduction in the retail price of gasoline by Rs 2 per litre and that of diesel by Re 1 per litre effective December 1, 2006 will be reflected in the WPI after another fortnight. In the projections and analysis made below, this impact has been factored in.

Two Alternate Inflation Scenarios

10. It is likely that the year-on-year WPI rate of inflation will approach 6.0% after mid-December 2006, and may even exceed this rate by mid-December itself, or at any rate in January 2007. While these rates are likely to weaken in March, it is possible that the fiscal year may close with inflation closer to 6.0%, higher than the 5.5% that has been projected for policy purposes.

11. There are two possible inflation scenarios in the run up to the end of this fiscal year (Table 3). While looking ahead, it should be noted that there has been a trend of provisional WPI values being adjusted upwards significantly during revision. Since the week ending 2 Sept 2006 and up to 23 September (for which revised data is available), the average upward revision has been 0.55 percentage points. For the 8-week period up to 23 September the upward revision was 0.32 percentage points. Normally the higher level of revised WPI is characteristic of a period of rising inflation. However, after a spike in prices the record tends to show a plateau effect. It is therefore possible that upward revisions of the same order may not be found to persist into November.

12. If however, some upward revision is indeed made, we should then consider the current level of inflation to be close to 5.7%, rather than the provisional number of 5.45%. By that reckoning it looks almost certain that WPI inflation rates will cross 6% in December 2006.

13. Under **Scenario-I**, we have assumed a business-as-usual situation, where the present price trends continue unimpeded for the balance of the fiscal year. In **Scenario-II**, we have incorporated the likely effects of the following policy options:

(i) Extend the duty-free import of wheat beyond the current fiscal year.

(ii) Ascertain and disseminate information on sowing and other activities for the ongoing *rabi* season/harvest (2006/07) such that market expectations may be formed on the basis of more complete information.

(iii) Reduce the import duty on import of non-ferrous metals with immediate effect

Table 3

Prospective WPI Inflation Rate for the Balance of the Fiscal Year

	Dec 2006	**Jan 2007**	**Feb 2007**	**Mar 2007**
Scenario I				
1. Foodgrain prices rises by a further 2% by the end of 2006 and by another 2% by the end of March 2007 2. Vegetable prices experience a smaller order of seasonal decline relative to last year 3. Grain mill product prices rise in parallel to foodgrain 4. Non-ferrous metal prices does not increase by more than 2% for the rest of 2006 and goes up by the same order in the first quarter of 2007	Provisional WPI rate is likely to touch 5.9% by mid-December and be just below 6.0% or cross it by the end of the month	Will be above 6.0% and may approach 6.5% in the second half of the month	At over 6.0% for most of the month	Above 6.0% by the end of March 07.
Scenario II				
1. Foodgrain stabilize more-or-less at current levels due to policy action and expectation of a better *rabi* harvest. 2. Vegetable prices experience the same order of seasonal decline as last year 3. Grain mill product prices also stabilize at current levels, like that of foodgrain 4. Non-ferrous metal prices does not increase much further due to reduction in import protection 5. Price increase in other manufactures also moderated due to a cut in import duties	Provisional WPI rate will approach 5.7% by mid-December and stay at around this level	Likely to cross 6.0% and stay there for most of the month, but not likely to go beyond low 6.0%'s.	Hover just above or below the 6.0% level	Slip below 6.0%, reaching 5.7% by the end of March 07.

Note: In the week ending 1 April 2006 there was a large increase in the WPI index. Consequently, there could be a sharp decline in the measure of WPI inflation rate for the last week of March 2007 which ends on 31 March if compared to the week ending 1 April, 2006 instead of week ending March 25, 2006.

Policy Recommendations

(i) Wheat Imports

14. Extend the wheat import policy free of duty beyond the current fiscal year and manage the supply position of pulses. Ascertain and disseminate information on sowing and other activities for the ongoing *rabi* season/harvest (2006/07) such that market expectations may be formed on the basis of more complete information.

(ii) Non-ferrous Metals

15. Table 4 shows non-ferrous metals contributing most to the increase in prices of this category along with the cumulative increase in the course of 2006/07 is also indicated.

Table 4
Contribution of Specific Metals to WPI inflation
(Up to the week ending 18 November 2006)

ITEM	Weight	Contribution to overall WPI inflation – cumulative 2006/07	Inflation during 2006/07 up to 18 Nov. 06
Non-ferrous metals	**1.466**	**0.385**	**26.3%**
Aluminum	0.853	0.115	13.5%
Coppers bars & rods	0.167	0.106	63.7%
Zinc ingots	0.046	0.018	38.0%
Zinc – other forms	0.099	0.060	61.9%
Lead	0.033	0.006	19.9%
Nickel alloy	0.058	0.028	47.6%
Brass	0.029	0.034	115.6%

16. Though the weights for these individual metals are small, the rate of inflation is so high that it is making a definitive impact on overall inflation. The domestic prices of these metals are being guided by international price movements as the price formula adopted by local manufacturers is import-parity based. The applicable import duty on these metals is presently 7.5%, except for nickel which is 5.0%. By reducing the import duty on all of these non-ferrous metals to 5% (same as for mild steel) some relief may become available – resulting if not in an actual reduction of existing price levels, at least in lower prospective increases.

17. Some part of the domestic consumption is imported and to that extent there will be a small revenue loss.

(iii) Money Supply

18. Inflation is a monetary phenomenon and is a function of the pace of monetary expansion also. Notwithstanding the initiatives towards monetary tightening by the RBI, all indicators of money supply are showing unusually strong growth for the third year in a row. Although there has been some slowing of credit expansion to the commercial sector since July 2006 (at least as compared to last year), aggregate M3 growth up to 10 November 2006 for this year was 8.7% compared to 7.1% for the corresponding period of the previous year. From the sources side, the net increase in foreign currency assets with the banking system provided the incremental supply, with the figure rising by Rs 58,709 crore this year (up to 10 November) or by 8.1%, compared to Rs. 33,978 crore or by 5.2% for the corresponding period of last year. The trend appears to have continued beyond 10 November as the reserve money (M1) statistics for week ending 24 November 2006 show that the net foreign currency assets of the RBI had increased by a further Rs. 27,000 crore (as opposed to a small decline in the corresponding fortnight of last year).

19. The economy is growing very fast, and admittedly this growth needs financing. However, it is important to manage this without stoking inflationary pressures. Containing money supply growth has to be an integral part of the policy package.