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The Growth-Inflation Dilemma: *Who is the Real Culprit ?*

The global financial crisis affected virtually every economy in the world, and India was no exception. But India recovered from the crisis much sooner than even other emerging economies. In the crisis year of 2008/09, growth dropped to 3.9 per cent, but it recovered reasonably well thereafter. In fact, in the two years after the crisis, 2008/09 and 2009/10, growth averaged 9.0 per cent which compares favourably with the average growth of 9.5 per cent in the three years before the crisis. However in 2012/13, growth dropped to 4.7 per cent, a poor return for an economy with great expectations (Figure 1).

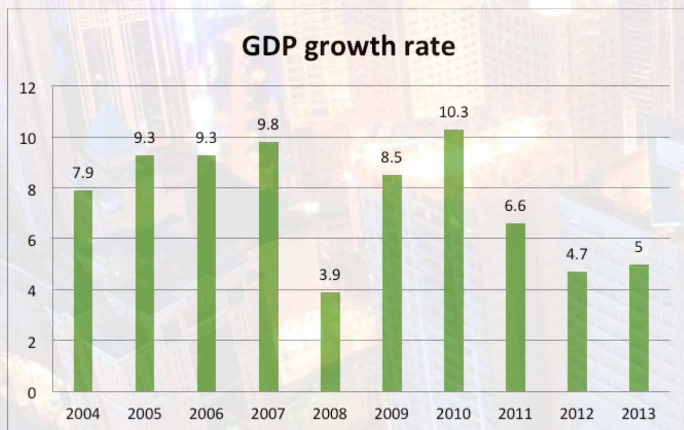

Figure 1: Sharp Decline in GDP growth[1]

To understand the latest downtrend, it is important first to understand the pre-crisis growth surge.

GDP = C + G + I + X;

It was the massive increase in capacity as investment (I) jumped from 26.9 per cent of GDP in 2003/04 to 38.1 per cent in 2007/08 (Figure 2 shows the downward trend for growth in gross fixed capital formation from very high levels in 2004/05 to very low levels in 2013/14).

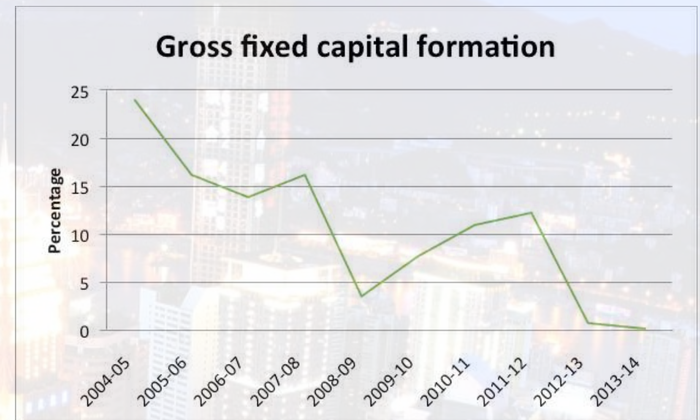

Figure 2: Decline in growth of gross fixed capital formation[2]

In the immediate post-crisis period, even as investment slowed, private consumption demand, which accounts for about 57 per cent of GDP, held up (Figure 4). This kept growth up but also fuelled inflation reflecting excess of demand over supply.

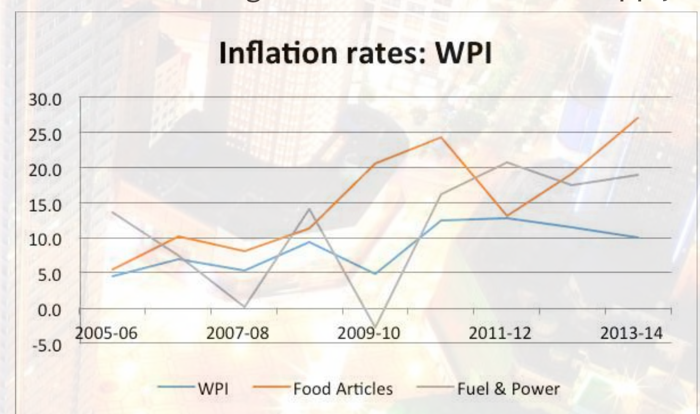

Figure 3: Rising levels of Inflation[3]

[1] http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?page=1

[2] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

[3] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

Inflation, as measured by the wholesale price index (WPI), started rising sharply (Refer to Figure 3 for WPI details and comparison with Food articles and Fuel prices) post 2009-10. The average inflation over the last three years has been significantly higher than the average inflation of 5.4 per cent during the previous decade (2000-10).

So, what explains the downturn in growth over the last three years? The answer would be a slowing of demand. Private investment reduced sharply, in part reflecting the global downturn, but largely owing to domestic factors. Profitability was impacted by increasing inflation, business sentiment was hit by rising fiscal deficit and governance concerns, all of which dampened investor perceptions on returns on investment.

On top of the decline in private investment, private consumption demand (C), too started slowing in recent years exacerbating the growth slowdown (Figure 4). It dropped to 4.1 per cent during 2013/14, down from an average of 8.3 per cent during the (2009-2012) period.

"Spending on fuel, food, fertiliser and other subsidies rose to 16% of India's total budget in the year ended March 2014 from 9% in 2004, while plan spending climbed to 30% from 26%, according to budget documents."

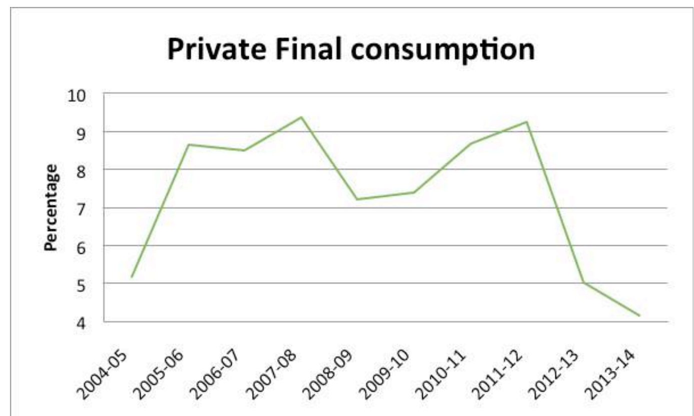

Figure 4: Decline in private consumption growth levels post 2011-12[4]

Inflation

A major driver for rise in inflation levels has been food inflation and the second major factor driving the current high trends of inflation has been rising fuel prices. India imports 80 per cent of its oil demand. The global price of oil is therefore an important variable in determining the inflation outlook. The depreciation of the rupee, starting October 2011, has compounded the inflationary impact of oil prices.

If the petroleum products were not subsidised, demand would arguably have declined in response to rising prices. But such a decline in demand was blocked by administered prices.

The increase in CAD is quite evidently a consequence of imports growing faster than exports. The increase in imports is largely accounted for by oil and gold imports. The reason oil imports have been price inelastic is due to the fact that nearly 60 per cent of petroleum products are subsidised by the government; oil demand to that extent does not adjust to price increases.

[4] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

Spending on fuel, food, fertiliser and other subsidies rose to 16% of India's total budget in the year ended March 2014 from 9% in 2004, while plan spending climbed to 30% from 26%, according to budget documents.

In the latest budget the FM proposed to overhaul food and fuel subsidies to make them more targeted while still providing protection for the marginalised and poor. A commission would be set up to ensure that the government spends its money efficiently, said the Finance Minister.

Growth-Inflation Dynamics

India's growth-inflation dynamics pre-crisis and post-crisis present a study in contrast. In the three year period before the crisis, the economy expanded by 9.5 per cent on average, aided by growth in fixed investment above 15 per cent per year. This expanded production capacity to match growing demand and kept inflation in check. Post-crisis, the story reversed. Investment declined to half its pre-crisis rate whereas consumption demand remained at the pre-crisis level until 2012, resulting in high inflation rates.

Large amount of government's budget spent on fuel subsidies resulted in higher imports and an artificially higher demand for petroleum products. Budget spent on subsidising petroleum products could have been better utilised in increasing government investments (G).

"For Indian consumers, the oil price crash translates into gross annual savings of Rs. 48,000 crore on fuel cost for transport"

The government, in October 2013, deregulated diesel prices. Following the decision, retail prices of the fuel now reflects international movement in oil prices. Aided by global crude oil price plunge, the lowest since 2009, government expects the oil subsidy bill to be dropped by 60 percent in 2014-15. The petroleum subsidy would account for 3.5 per cent of the government's total expenditure in the current financial year as against 5.4 per cent in the previous financial year, the decline mainly on account of diesel deregulation.

For Indian consumers, the oil price crash translates into gross annual savings of Rs.48, 000 crore on fuel cost for transport. This includes Rs.28, 800 crore savings for truck owners, Rs.9, 000 crore for petrol car owners, Rs.8, 600 crore for two-wheeler owners and Rs.800 crore for diesel car owners. The savings on fuel prices will increase the discretionary spending of customers, leading to a pickup in India's consumption. For the government, the crash means reduced pressure on current account deficit (CAD). It will also help create a healthy foreign exchange reserve, which will boost the rupee's stability against the dollar.

The reduction in subsidies will reflect true demand, improve efficiency and provide a much better investment environment.

To sum up, today's investment is tomorrow's production capacity. India needs to not only reverse the investment downturn but also increase it significantly to raise production to match the growing consumption demand. Increase in investment is necessary also to raise production for exports. Making this happen requires a response from the government by way of providing public goods and creating a conducive environment for private investment.

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