PRICES ELEVATED AS COST PASS-THROUGH INCOMPLETE

How soon will RBI get a handle on sticky core inflation?

Robust demand for services, non-availability of cheaper MSME products inflate prices

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A CONSPICUOUS FEATURE of Wednesday's commentary by the Monetary Policy Committee (MPC) — and the accompanying statement issued by the Reserve Bank of India (RBI) governor — was the concern over the stubbornness of "core inflation" and the "ongoing pass-through of input costs to output prices, especially in services" that could continue to exert pressures on it.

In fact, core inflation inched up to 6.1% in December from 6% in November, even as the price pressures measured by the consumer food price index saw a sequential decline from 4.67% to 4.19%, enabled by a sharp deflation in vegetables. The stickiness is broad-based, with 56% of the items of the 'core basket' — essentially non-food, non-fuel items, which include both manufactured products and services — still showing inflation above 6%.

Most analysts expect the latest rate hike to be the terminal one in the current cycle and the MPC to pause thereafter. However, if core inflation remains unyielding for a few more months, the repo rate could remain at 6.5% for longer.

What causes the stickiness of core inflation? Economists say it has largely resulted from the yet-to-be-completed pass-through of high input prices by manufacturers and service providers. A structural change in the economy during the pandemic and thereafter, caused by the "formalisation" process, and the hikes in import tariffs, which jacked up costs across various sectors, seem to have contributed too.

"Both the manufacturing and services sectors have been hit by higher input costs, which are still in the process of being transmitted. This is why core inflation remains sticky. The process of passing on higher input costs is not yet over and hence we may have to live with it for a longer period of time," Madan Sabnavis, chief economist at Bank of Baroda, said.

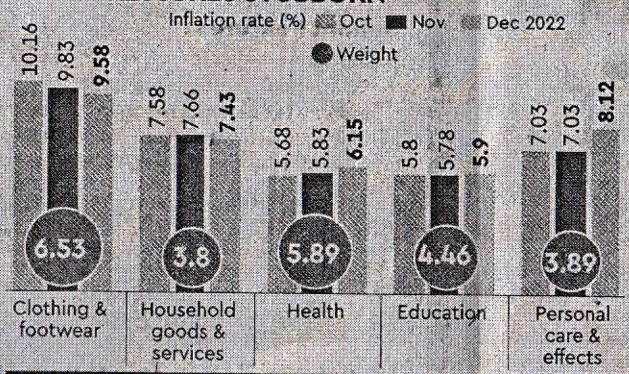
In the CPI basket, inflation in 'clothing and footwear', 'personal care and effects', 'health' and 'household goods and services' are still unyielding. These items have significant weights in the CPI (see chart). In the case of education, the price pressures are still going up.

Aditi Nayar, principal economist at Icra, said: "We expect the core inflation to remain elevated in Q4FY23, given the continued pass-through of higher input costs by producers and sustained robust demand for services. There is some anecdotal evidence of higher inflation passing through to segments such as rentals. Moreover, some services may have seen a large increase in prices after an extended period of low demand amid the pandemic."

There are expectations that softer global commodities and fall in wholesale price inflation could aid the process of decline in core inflation. But, as the MPC said, the inflation outlook is "clouded" by continuing uncertainties from geopolitical tensions, volatile global financial markets and rising non-oil commodity prices.

Sabnavis said: "One can see a series of waves. For example, entertainment costs have gone up, which is keeping recreation component costs high. Educational institutions have revised fees as costs have moved up with more technology being brought in. Hospital and medicare charges have been revised upwards, after Covid. In all these cases, inflation is around 5-6%."

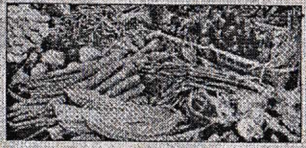
PRICE PRESSURES STUBBORN

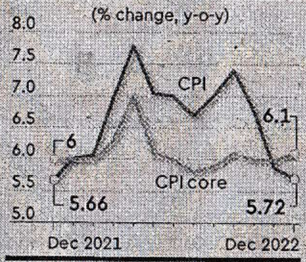


Price pressures in manufactured products are less susceptible to small fluctuations in market, while food prices are highly elastic to demand-supply dynamics. Maximum retail prices aren't promptly reduced when raw material prices come down. For instance, in the case of the 'clothing and footwear' segment, higher cost of chemicals linked with crude had pushed up input costs and MRPs. These prices could remain sticky for a while, even though the inputs have become less expensive. "I would tend to think that for another 6 months this process (pass-through of input costs) will continue," Sabnavis said, adding that core inflation may therefore stay around 6% during the period. A favourable base effect will then come into play and moderate the number.

Not just transmission of higher costs, but higher demand too is inflating the prices in certain segments. Saugata Bhattacharya, executive vice-president and chief economist at Axis Bank, said: "The contribution of certain items (to sticky core inflation), like 'personal care', which includes gold and precious metals, has been rising since July 2022. Part of the reason (for persistently high core inflation) are higher input costs, but there is a demand element to this as well, since retailer have been able to pass through these costs to end consumers."

There are slightly different views among economists on the impact of formalisation on the current inflation numbers. With formalisation of the economy, cheaper options of goods and services from the unorganised sector are either no longer available or their availability has diminished, Sunil Kumar Sinha, senior director - public finance and principal economist at India Ratings & Research, observed that while this has resulted in higher inflation, its impact could be restricted for only one cycle, as inflation is typically calculated on a year-on-year basis.





Bhattacharya said GST and formalisation are "not new" and have been diffusing steadily through the manufacturing ecosystem over the past few years. "Supply chain issues might have contributed in the initial years of the pandemic, but these have reportedly largely abated last year," he said.

Have the increases in import tariffs on a large number of items over the last couple of years jacked up prices? "Import tariffs would have added to costs, but part of the increases were introduced in FY22, with some others in FY23, so these are unlikely to have contributed significantly to the high inflation in FY23," Bhattacharya said.

The short-term outlook on core inflation is not very sanguine. According to Dharmakirti Joshi, chief economist at Crisil, core inflation is expected to come down in the coming fiscal year as rate hikes will filter through to demand. He, however, added that the process would be "gradual" as in addition to commodities, the services sector was also facing rising cost pressures. "With the continued revival in contact-based services, the pressure on services inflation will continue," he said. Bhattacharya predicted that core inflation is likely to average 6% in Q4FY23 and 5.3% in FY24, as against average 5.1% headline retail inflation.

"The Ukraine war caused distortions in supplies, which pushed up wheat prices in India. This has led to a permanent increase in prices that seeps through manufactured products like bakery items and also in higher costs of menus in restaurants, which could become permanent. Therefore the combination of formalisation and globalisation have been responsible for speeding up the process of transmission of costs," Sabnavis explained.

Sinha drew attention to considerable uncertainties over the likely trajectory of global commodity prices, including price of crude oil, and said, "If they remain where they are, core inflation will likely come down... Hopefully, manufacturers will slow down the onward transmission of input costs," he said.

What could the government do to contain core inflation and supplement the efforts of the MPC? Given the fiscal constraints, the government may not opt for indirect tax reliefs like the cuts in auto fuel taxes announced in last May to cool prices. Also, the GST Council is looking at increases the rates to raise the weighted average rate to somewhere around the revenue neutral rate. While these rate revisions may not happen before the general elections in May-June 2024, substantive rate reductions are highly unlikely in the interim. Addressing supply chain issues, particularly in the food segment, is what the government could do and the robust rabi crops would stand it in good stead.