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The Good Side Of Inflation

Accelerating prices make govt debt management easier. Higher food prices mean bigger farmer income

Somnath Mukherjee

Inflation's reared its head as the devil of our times, globally. A bit of a nasty devil too, given just how long it has been sleeping.

India has a politically fraught relationship with inflation. Even when headline inflation numbers are benign, charges of "price rise" fly thick and fast. When the numbers are elevated, as they are today, they obviously acquire a sharper edge. Paradoxically, inflation isn't a monochromatic evil.

For starters, inflation, in moderate doses, is a great aid to the government expanding fiscal intervention amid economic sluggishness. After many years in the 70-75% (of GDP) range, India's public debt-to-GDP ratio has shot up in the last two years.

Partly on account of the sharp slowdown in growth and partly on account of higher government borrowing to support the Covid-impacted economy, India's debt-to-GDP touched 87% in the fiscal year ending March 2022. It is expected to settle in the 85-90% range in the foreseeable future.

That is likely the peak range for comfort – both for a government that has made fiscal cautiousness its calling card as well as for international ratings agencies. In other words, even as India struggles with a K-shaped recovery and myriad imported challenges, the government has limited headroom to expand fiscal intervention.

HIGH PRICES
BIG QUESTIONS

Unless, a high-ish inflation, trending at a rate higher than the yields on government bonds, inflates the debt away faster, creating the headroom for the government to expand the fisc.

This is how India managed to maintain an elevated level of fiscal deficit (including off-budget public spends like oil subsidies) for 5-6 years post the Global Financial Crisis, without blowing out on debt-to-GDP ratios. It was made possible because of high single-digit, near double-digit inflation for most of that period.

There have been reports in the media that the finance ministry has asked RBI to take measures to cool off government yields, even as RBI undertook a surprise policy rate hike last week. While not confirmed yet, within moderation, it's a logical ask from the perspective of the ministry. High inflation with negative risk-free interest rates is an implicit tax – on savers – to fund fiscal support to those who don't have surplus savings and to kickstart broad-based growth.

A somewhat less straightforward, but perhaps more high-impact consequence of inflation is a partial reversal of the terms of trade (ToT) in agriculture. It's well-known that ToT in farming has been on a secular decline. Even during periods of food price hikes – something that happens periodically in India – farmgate prices have kept capturing lesser and lesser of those hikes.

Especially in the last few years, when the government, with a hawk-eye on inflation, has kept MSPs' growth at modest levels and global food prices have also largely been soft.

It's well-known that the terms of trade in farming have been on a secular decline. But now, farmgate food price inflation is trending significantly above retail price inflation. Price increases are not restricted to cereals like wheat. Milk, cotton, edible oils – the anecdotal evidence of higher farmgate prices is adding up. It's an income transfer from urban India to the farmers

This is partially reflected in the relative movement in CPI and WPI food inflation numbers. Even when retail inflation, represented by CPI-food inflation went up, farmgate prices, which can be proxied by WPI-primary articles, lagged behind. In fact, the spread between the two (WPI-primary and CPI-food) has been negative for most years between 2012 and 2021.

Shorn of jargon, it meant that bulk of the retail food price inflation was accruing to parts of the value chain outside of the farmer. A synchronised inflation in the last one year – substantial increase in MSP last year and a global uptick in food prices as a result of the war in Ukraine – has significantly reversed the trend. Farmgate food price inflation is trending significantly above retail price inflation.

Several other high-frequency indicators support the same hypothesis. Food Corporation of India's wheat procurement was down 44% till May 1. This was primarily on account of private traders offering higher prices as export demand has shot up and expectation of further price increases.

The price increases are not restricted to cereals like wheat. Milk, cotton, edible oils – the anecdotal evidence of higher farmgate prices is adding up. Perhaps it's temporary, but ToT is shifting just a tad bit in favour of the farmer due to the current inflationary spell. In other words, it's an income transfer from urban India to the farmers.

RS Sodhi, the MD of Amul, said in an interview to *The Economic Times* some time ago, "Food inflation for urban India is rising income for rural India." This is perhaps a little glib. The real issue is realisation by farmers rather than just headline prices, but it is a point well made.

In short, inflation is a policy paradox, like Hamlet's "To be or not to be" soliloquy. Policymakers need to find a balance, rather than condemning inflation as an unmitigated evil that it is projected to be in popular discourse.

The writer is the Managing Partner and CIO, ASK Wealth Advisors. Views are personal

This is the third of a series of commentaries on inflation and its implications