

Quickonomics

January 13, 2020

Noise and signal

Retail inflation has pierced past the upper bound of the Reserve Bank of India (RBI)'s 2-6% target.

Exactly a year ago, it was dormant around 2% and until August 2019, humming along 3%.

Along with slowing growth, more-than-desirable inflation raises the sceptre of stagflation (where inflation rises even as output and employment fall)

An unwanted complication in an already slowing economy that central banks dislike.

That's also a big reason why an inflation-targeting Monetary Policy Committee (MPC) stood pat during its December review, going against the street consensus.

But just how valid is this concern?

A closer look shows the current spike in inflation comes from transitory or idiosyncratic factors.

Let's call them 'noise.'

Theoretically, the noise in consumer price index (CPI)-based inflation reflects sharp price movements in certain volatile categories. These happen because of commodity price fluctuations, and weather and supply shocks.

Typically, they don't last long, so are unlikely to become a cause of sustained increase or decrease in inflation.

In India, and generally, too, fuel and food are way more volatile¹ than core inflation². Put another way, they're more prone to making noise.

Remove noise, get the signal

Now, core is what's left if you remove noise.

That, then, is the 'signal', which indicates the underlying inflation in an economy.

Core has a greater weight (51.8%) in the CPI series, than food and fuel (48.2%).

The share of noise in headline inflation has gotten louder, from a miniscule 18.5% in April 2019 to 74.9% in December.

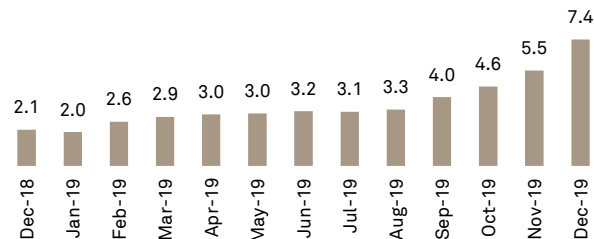
Also, pay attention: Much of this rise is on account of food inflation. The fuel category was witnessing deflation till November and turned marginally positive in December.

In short, food is the current noisemaker.

¹Measured by standard deviation (Jan 2015-Dec 2019)

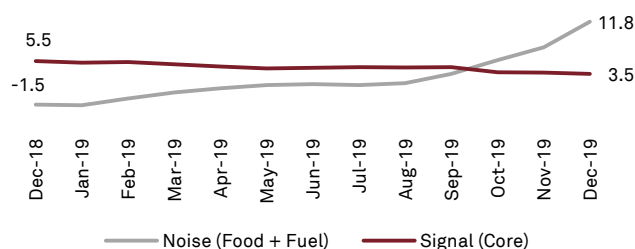
²Core measures inflation sans food and fuel

Headline inflation is getting amplified...



Source: National Statistical Office, CRISIL

..but there's signal, and there's noise



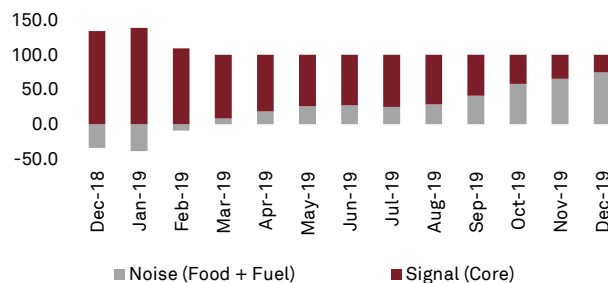
Source: National Statistical Office, CRISIL

Fuel and food (noise) swing more wildly

Standard deviation of inflation



More noise is getting into the headline...



Source: National Statistical Office, CRISIL

Hot veggies

But while food inflation has ascended to double digits, it is not broad-based. It is specifically in vegetables, followed by pulses, which are behind the surge.

If you exclude them, food inflation is still 5%, which is a 33-month high.

Does that mean the RBI can pass over the noise as just noise?

No. Here's why:

1. The RBI targets headline inflation. So it needs to contain that even if the rise is on account of the noise elements – say food, in this case
2. As the shocks to food and fuel inflation are generally more perceptible, they move household inflation expectations. RBI data shows that 3-month-ahead expectations have gone up from 8.0% in September 2019 to 9.2% in November, and 1-year-ahead from 8.1% to 9.9%
3. Core inflation could get a jolt, too, from a hike in telecom tariffs
4. Global food prices were at a five-year high in December (Food and Agriculture Organization)

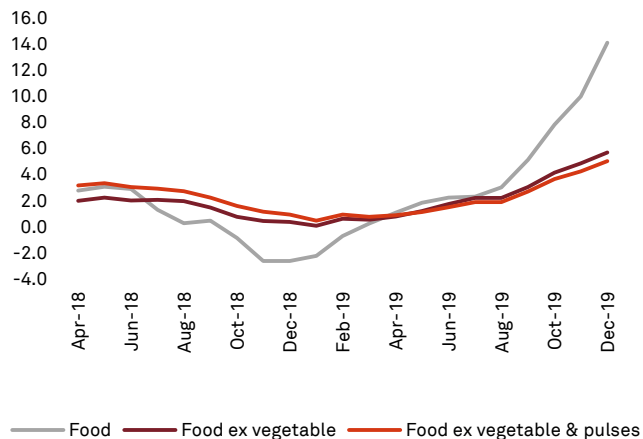
Quickenomics will take a look at data points and try to explain their significance.

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...but it is contained within a few food items



Source: National Statistical Office, CRISIL

If food inflation returns to its trend level of over 5%, then maintaining the 4% headline target will be challenging once the economy – and along with it, core inflation – rebounds.

The fiscal 2021 Union Budget can address this in two ways:

1. By pushing supply-side reforms in agriculture that improve efficiency and cut wastage, the noise element in food inflation can be reduced; and,
2. By driving reforms in healthcare and education – the two sticky parts of core inflation – the signal can be tamed.

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