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CPI a lousy measure for monetary policy-making: Pronab Sen

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SUMMARY

Former chief statistician talks about debate over the right inflation gauge for monetary policy formulation.

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Pronab Sen, chairman, National Stastistical Commission and former chief statistician talks about the debate over (which is) the right inflation gauge for monetary policy formulation, the dichotomy between wholesale price index (WPI) and the new consumer price index (CPI), and the IIP data volatility in an interview with FE's Rajkumar Ray, Banikinkar Pattanayak and KG Narendranath. He also hints that since the producer's inflation expectation has sharply come down, the RBI may have a reason to start lowering policy rates. Excerpts:

Q: Can the new consumer price index (CPI) inflation be a benchmark for monetary policy-making?

The CPI data series is only three years old. With three years of data, you can't do any analytical work. You need minimum 10 years of time-series data to look at various aspects -- like causality effects –- for meaningful policy use. To use the CPI as a core inflation benchmark for policy purposes, I think, is not possible now because it does not have the time series. It can be used as a descriptive index but not for policy purposes.

Q: Even after ten years, will the CPI still be a good gauge of inflation for monetary policy-making?

I think even after a decade, the CPI will still be a lousy measure for monetary policy-making in a country like India. This is because of the very high weightage given to food and fuel items in the CPI. While food items have a 49.71% (rural and urban combined) weightage in the CPI, fuel items make up for 9.49%. In other words, nearly 60% of the weightage is on primary products, which are not

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particularly sensitive to monetary policy. Moreover, the CPI is much more geographically sensitive than the WPI (wholesale price index), which means localised inflationary processes arising out of structural problems will show up in the CPI but not in the WPI.

Unlike WPI, CPI captures services but mostly those which are truly retail in nature, and many as input services for goods sold in retail.

Q: Even core inflation as measured by the WPI and the CPI shows a wide divergence. How do you explain that?

There is a lag effect. One has to look at the composition of the product basket. The CPI is not a measure of inputs but of final goods, whereas the WPI captures both inputs and final goods. Within a value chain, you can have some items where there is no pricing power -- that is what is getting reflected in low WPI core inflation due to loss of pricing power of manufacturers. However, the retail margins can be fairly high, which will show up in a higher core CPI inflation. One has to drill down a little more.

You also have to look at how the data are collected. In case of the WPI, we take the wholesale prices. In case of the CPI, you do a market survey and determine a dominant brand in a geographical area and once it is chosen, the price quotation is taken. The dominant brand can be different for different areas and need not be the highest-selling brand of the country. The price changes can also differ among the brands, and reflect local features.

Q: Experts are doubting the CPI data on grounds of data discrepancies. Despite having different weightage of food, fuel, manufactured products and services, why are the rural and urban CPI inflation rates have more or less moved together for several months between June 2012 and May 2013?

Such convergence is possible. The difference between in the weightage of food products in the new CPI rural and CPI urban – 59.31% and 37.15%, respectively-- is less than widely presumed. In contrast, the weightage of food in CPI-AL (CPI for Agricultural Labourers) is 73%. That is why you see such a large divergence between new CPI and CPI-AL. The gap is much less for the new CPI rural and CPI urban.

Of course, the new CPI is, in a way, more robust as it even gives the geographical trend. The weightage of food and other items vary a lot among states.

The rural and urban inflation rates may show similar trend with greater integration of markets. Aspirations and tastes (of rural consumers) are changing and the consumption patterns are converging in rural and urban areas.

Q: Why did the WPI food inflation show a sharper rise than CPI food inflation in August even though food items have a greater weightage in the CPI?

Even this is possible. The retail margins used to be as high as 40-50%. There can be a situation where retailers are unable to maintain such high margins and are cutting down on them. In such a scenario, it's possible that retail prices can rise at a slower pace even as wholesale prices rise faster. There exists a bigger scope for margin compression at the retail level.

Q: Is there a need to fine-tune the CPI data?

Not much.

Q: Coming to the index of industrial production (IIP), we see a higher degree of volatility in recent years, especially for capital goods. This is posing a challenge to the government and RBI in framing policies. What's your take on this?

Volatility has been there in the IIP all along. Let me give you an example. When a company supplies a boiler after four months, the month when it is delivered shows a spike in the capital goods index. Now you can't have a situation when the boiler is delivered in bits and pieces over those four months. Even take the example of electric cables where the orders come in for thousands of kilometres. In the month these cables are delivered, the index will show a sudden jump and when they are being manufactured, you don't see them getting reflected in the index.

Also, people keep missing out on things. When we changed the IIP base to 2004-05, we dropped the small scale industries, which comprised 40% of industrial production. Earlier, you had a situation when the IIP was coming out with just 20% responses. That was ridiculous. You had a comprehensive index and bad data. Now, the IIP is only for the corporate sector and does not cover SSIs. Now we get 65% of the response in the first estimate and 90% in the first revision of the monthly IIP. So we now have a partial index with good data. The problem is that people forget this partial coverage (when they speak of volatility).

Q: But in the absence of SSIs, won't the IIP show an incomplete picture?

The assumption is that SSIs behave identically with big companies. Over the long term, this is correct. But there are also times when they move in opposite directions. My sense is that at present that is the case. An Indian SSI is typically a single-market entity -- it either caters for the domestic market or exports; there are very few SSIs that cater to both the sectors as bigger companies do. Most SSIs cater for the domestic market and except for FMCG items, most of the rural demand is met by SSIs. My estimate is that SSIs have done a lot better in the past few months. Although this is not reflected in the IIP numbers, it will show up in the GDP numbers a year later. We are getting excessively pessimistic over the IIP.

You take out capital goods and take a three-month moving average, then add it back. This version of the IIP will be relatively stable. (But stability of data is not an end in itself as much its veracity).

Q: What's the main reason for a sharp slowdown in the IIP and the GDP growth rates?

Both the IIP and the national income data show one common thing -- you have had very little corporate investment. Investment has to precede production. At the moment, most companies have capacity constraints.

Q: Doesn't this slowdown in investment and growth make a strong case for the Reserve Bank of India to cut rates?

The whole trick of monetary policy is managing inflationary expectations. If the producer feels he can pass on the prices of inputs, he is ready to buy the inputs at a higher price, which, in turn, stokes inflation. Containing this expectation is what this (monetary) policy is all about.

But here again, you have to think about whose expectations you are looking at. First, the consumer's expectation is the most important because it affects consumption and financial savings. Second, the household as a supplier of labour also looks at inflation, which leads to higher demand for a wage revision. Third, the producer also looks at inflation for pricing the final goods. In 2011 and 2012, workers got huge wage increases as producers could pass on the wage hikes to consumers. Today, it is gone and the producer's inflation expectation has sharply come down. That explains the fall in core manufacturing inflation. In fact, lots of companies are looking at deflation -- the auto and the white goods sectors, to name a few, and that's why they are offering huge discounts on their products.

Q: The finance ministry is still hopeful of a GDP growth rate of 5-5.5% in 2013-14 even though private brokerages, and now the IMF, have lowered their forecasts to less than 5%. What's your expectation?

I think the finance ministry's projection is closer to reality. Once the SSI data come, the GDP numbers for 2012-13 and 2013-14 will show higher growth rates. That will happen when the first or second revision comes a year later.

Q: Coming back to food inflation, is it high primarily because of supply bottlenecks or changes in consumption pattern?

Over the years, there has been a significant increase in the production of vegetables. Fruit (supply) is a problem and it can't be addressed overnight. It will take at least 7-8 years more to address the demand-supply mismatch. Overall, responses (in supply) have taken place. Logistic chains are not as good as it should be, but there has been some improvement in the supply chain too. The problem is elsewhere. Take the instance of onion--Maharashtra and Karnataka produce roughly 30% and 15%, respectively, of the country's total output. Similar is the case for potatoes where West Bengal and Uttar Pradesh make up for bulk of the produce. In case of Brinjal, major chunk comes from West Bengal. With the dominance of some states in some vegetables, any problem in the local conditions or the particular supply chain can create havoc.

We still don't know what's happening in the trade between the farmers and consumers. While the farmer gets a low price, the consumer is paying a high price. In between, we don't know how prices are being marked up. This (marking up) can be eliminated if you allow retailers to buy directly from farmers.

Q: Can this problem be resolved by scrapping the APMC Acts by states?

Anyway the APMC Act should be done away with, but it is not a panacea. For instance, Bihar did it. One of the first things that Nitish Kumar did was that. But it has now created another problem -- the private traders have monopolised the mandis. This needs to be addressed too.

Q: Considering that access to authentic and timely economic data collection is still a problem, are you planning some hard reforms?

A lot of that (reform) has to do with cleaning the existing system. We don't have a policy on statistics. We have 38 ministries and departments supplying the data. They are supplying the data according to their own set of rules and they feel it is the best they can do. We need to have a national policy. I am trying to draw up a policy that will underline what is expected of each ministry as far as collecting, compiling and furnishing the data is concerned.

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