

Inflation: Deflating Currency, Fixed Deposits

Inflation according to government figures is little less than 8 per cent. Government claims that it is poised to do down in next few months. We beg to differ on both counts. Our estimate is that inflation is more than 10 per cent. While it may come down in next few months there is a significant risk that it will continue to remain high and possibly go higher in longer run. We present our case below.

Crude oil is presently trading at 130 USD per barrel. At these prices the total under recovery for oil sector would be in excess of 2 lakh crores this year. While a portion of this deficit will be borne by ONGC, GAIL etc. through reduced realisations, the rest to the tune of one and a half lakh crores has to be borne out by government directly through oil bonds or indirectly through reduced tax revenues from oil marketing companies. The loss to government will be in excess of 3 per cent of the GDP. Even if this deficit is being funded using bonds it is more like printing money for expenditure which adds negative value to economy. Printing money is always inflationary and printing it at such a scale for subsidising fuel would prove disastrous in long run. It would prevent the move towards greater fuel efficiency and lead to bigger deficits and even higher oil prices.

At this point of time our estimate is if oil prices are aligned to market prices without any additional taxes inflation would increase by 5 per cent. This increase in inflation would fuel further second round effects culminating in overall increase in inflation of at least 7 per cent and most likely it would be more than that. The fact that this has not happened makes the situation only worse. Cumulative inflationary effects would much higher in current scenario.

The second major inflation source which has been suppressed for time being is food grains especially rice. The price of rice in international market is close to Rs 45 per kg currently. This is the wholesale price. Consumer prices would be higher. In India the wholesale prices are one fourth of that level. Prices have increased for wheat, corn and soyabean as well. India has been insulated from these prices by banning of exports of these items. In long and medium term this step would prove inflationary. Lower prices do not provide proper incentives to farmers to raise production. If the farmers are paid Rs 20 per kg of rice they would have incentive to grow more rice which could eventually drive down the global prices as well. In present condition, if crops fail or there is reduction of grains output, India would have to import food grains at much higher prices increasing inflation. Instead of making a move towards market prices the government has introduced scheme of waiving loans to farmers to the tune of Rs 72,000 crores. This is again an example of printing money for something, which would lead to no positive change in productivity of the farm sector. Just aligning the rice prices to half of global market level will raise the inflation by 2 percentages.

Unadjusted inflation would have been at 15 per cent. The government is engaging in market manipulation to keep it low in short term. Not only will this be unsustainable, inflationary pressure will be higher in longer term due to absence of incentives for either increasing grain production or improving fuel efficiency. Holding currency for investment seems like the worst of the decisions. Every year the purchasing power is going down by a whopping 10 per cent. The current rate of returns for fixed deposit in our estimate will reduce the purchasing power of money by 3-4 per cent per annum. There is also a small chance that returns for fixed deposits would be much worse than that and depositors would lose most of their capital. The rational decision according to us would be to buy stocks of companies which have a pricing power and are not richly valued. Most of the large capitalisation companies and mutual fund holdings do not fall in that category. However a number of such options do exist. Watch this space and contact us for details.