

PANDEMIC, DISCRETIONARY SPENDS AND HEADLINE INFLATION: INFLATION BEGINNING DEC'20 IS HIGHER THAN REPORTED NUMBERS

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CPI inflation slowed to 4.29% in Apr'21 from 5.52% in Mar'21, primarily due to easing food prices. However, even as the pandemic rages through India, it is worthwhile to look beyond the headline inflation. In particular, rural core has now jumped to 6.4% in Apr'21 and would rise further in May'21. Increasing health expenditure because of the pandemic is having a meaningful impact in rural areas. Item-wise inflation of Health CPI shows persistent month-on-month increase in inflation of non-institutional medicine, and X-ray, ECG, pathological tests. Even hospital and nursing home charges have increased in Apr'21.

In the current pandemic, headline inflation may not be correct to look at. A more important price concept is the relative prices which are not a monetary phenomenon but their movements convey important information about the scarcity of particular goods and services as now like health. For example, overall CPI declined in Apr'21 because of significant decline in food CPI, but when the relative prices of food items is compared to overall CPI the deceleration was not sharp as it was seen in actual food CPI. Similarly, for certain items like fuel and health the increase in relative prices is maximum. Interestingly, the core CPI which was showing a decline of 57 bps increased in relative terms by 18 points. We believe such distortions in relative prices must be looked through now as it could have an important impact on ratcheting up future inflationary expectations. Against this backdrop, three conclusions are in order.

First, health expenditure currently at 5% of overall PFCE, could increase by at least 11% from the current level. This is likely to also result in squeeze in expenditure on other items of discretionary consumption, a recipe for a cutback in consumption spending.

Second, the increase in fuel prices since Dec'20, as Government is facing a collapse in revenue receipts, is having a direct impact on squeeze in consumption spending on discretionary items, other than on health which is currently unavoidable. But the most definitive conclusion when we re-estimated CPI headline by using SBI card spend data and through Paasche's Index, since Dec'20, is that our CPI computed inflation for the 5 month ended Apr'21 is higher than CSO estimate on an average by 60 basis points (Apr'21 computed inflation is at 5.35%). This has happened as spend on oil in December has crowded out the spending on other discretionary items, like health, grocery and utility services that was the trend in earlier months which is worrisome. In fact, the share of non discretionary spend has jumped to 59% in Apr'21 from 52% in March. This demands a cut in oil prices through tax rationalization, otherwise consumers' non discretionary spending will continue to get distorted and crowd out discretionary expenses. This will also impart a clear upward bias in inflation. Furthermore, there has been an increase in use of online delivery platforms, which is not considered by NSO and if NSO considers online prices, there would be 10/15 bps impact on CPI inflation.

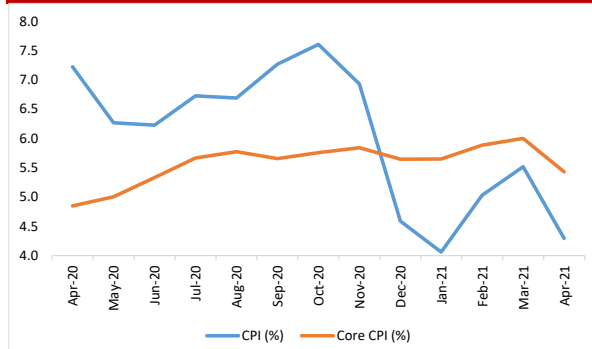
Third, rise in commodity prices have fuelled market expectation of possible rate hike by US Federal Reserve. US job openings surged in March to a record high, underscoring a rapid increase in labour demand as vaccinations accelerate and states reopen their economies. But it appears companies are unable to find the workers they need, hence vacancies were not filled. However, policy circles still maintain that current inflationary pressure in the US economy is transitory in nature and may not ultimately call for rate hike. We, however, will continue to watch this space for any future trends.

All this will make it difficult for RBI to manage the conflicting targets of inflation, exchange rate and adequate liquidity amidst weak growth.

CPI INFLATION FOR APR-21

- ◆ CPI inflation slowed to 4.29% in Apr'21 from 5.52% in Mar'21, mainly due to easing food prices. Inflation in the food basket was 2.02% in Apr, down from 4.87% in the preceding month. However, inflation in fuel & light increased to 7.76% in Apr from 6.17% in Mar.
- ◆ Meanwhile, core inflation has remained stubbornly sticky, close to 6% for the past nine months to Mar'21 and only moderated slightly to 5.43% in Apr'21 from 6.0% in Mar'21. Amongst the components, transport and communication, recreation and amusement and education witnessed maximum decline in inflation. Even the price of household goods and services and personal care has declined in the latest month.

CPI and Core-CPI Inflation



Source: SBI Research

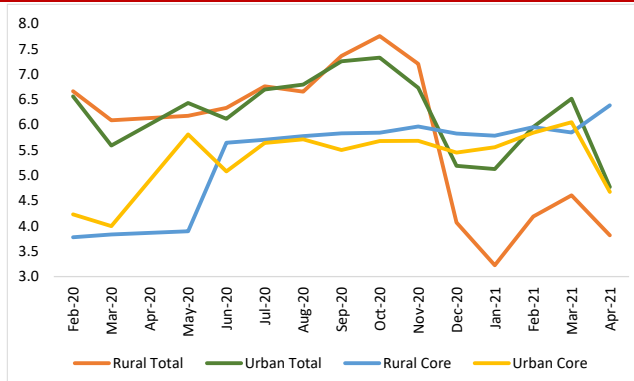
RURAL AND URBAN CPI INFLATION

- ◆ CPI-urban inflation which was lower than rural inflation during Sep'20-Nov'20, moved up thereafter, with the former now more than the latter by around 95 bps in Apr'21. Higher urban inflation compared to rural inflation is mainly due to the difference in inflation in fuel and light, which is much higher in urban areas. This can be attributed to lower consumption of petrol and diesel in rural areas.
- ◆ Meanwhile, core inflation in rural areas has been more than that in urban areas since Jun'20, except for Mar'21. The gap between rural core inflation and urban core has increased in Apr'21 to more than 170 bps.
- ◆ Rural core has increased significantly in Apr'21 to 6.39% from 5.85% in the previous month. The major cause for the rise in rural core is the increase in health inflation whose weighted contribution has increased to 0.50% from 0.36% in Mar'21. Inflation in personal care and education has also risen marginally.
- ◆ Item-wise inflation of Health CPI shows persistent month-on-month increase in inflation of non-institutional medicine, and X-ray, ECG, pathological tests etc. this fiscal. Even hospital and nursing home charges increased again in Apr'21 after a near zero month-on-month change in Mar'21.

HEALTH EXPENDITURE COULD RISE ON AN AVERAGE BY 11% IN FAMILY CONSUMPTION BUDGET AS PANDEMIC RAGES

- ◆ We believe health expenditure will rise significantly because of the pandemic. It may be noted that health expenditure was around Rs 6 lakh crore / 5% of Private Final Consumption Expenditure /PFCE. Notably, there could 3 impacts.
- ◆ **First, the price impact.** There has been an increase in weighted contribution of health inflation in CPI inflation. Taking the share of health expenditure in PFCE for FY20 and adjusting it for such increase in CPI inflation, we estimate that health expenditure in family budget will increase by at least around Rs 15,000 crore, because of the increase in prices.
- ◆ **Second, the quantity impact.** Further, because of COVID hospitalisation cost of people have significantly increased. Based on current trends, if 30% of the infected people get hospitalised and amongst them 30% opt for private hospital and taking a conservative Rs 1.5 lakh as the cost of entire treatment (including medicines, hospitalisation charges, PPE kit etc) total expenditure of hospitalisation comes around Rs 35,000 crore because of increased consumption of health services.

Rural and Urban CPI Inflation



Source: SBI Research

Health Expenditure Estimate (Rs crore)

Price effect (Impact of Inflation)	15000
Quantity effect (Impact of hospitalisation)	35000
Income effect (Impact of reduced income)	16000
Total Impact due to increased Health Expenditure	66000
Health Expenditure in FY20	600000
Total impact as % of Health Expenditure	11%

Source: SBI Research

- ◆ **Third, the income effect.** In addition to the above two effects, there is also an income effect due to lower per capita income, which has reportedly declined by Rs 8637 in FY21 from FY20 (CSO estimates). Assuming on a conservative basis the income of private and unorganised sector employees has been impacted, as per our calculation the **income effect comes** to around Rs 16,000 crore. This loss in income could be an additional burden and could be a diversion from other discretionary spends to health.
- ◆ **Thus total health expenditure is likely to increase by Rs 66,000 crore, which is 11% of the health expenditure incurred in FY20.**

A BETTER MEASURE IN CURRENT CIRCUMSTANCES: RELATIVE PRICE VIS-À-VIS ACTUAL CPI

- ◆ We believe that in the current circumstances, relative prices is a much better concept than headline inflation as the pandemic has induced a disproportionate increase in spending items on non discretionary products like fuel prices and in discretionary product spending like health.
- ◆ A relative price is the price of a commodity such as a good or service in terms of another; i.e., the ratio of two prices. Though relative-price changes are strictly not a monetary phenomenon but their movements convey important information about the scarcity of particular goods and services.

- ◆ A rising relative price indicates that demand is outstripping supply (or that supply is falling behind demand), while a falling relative price denotes just the opposite. A rising relative price induces consumers to conserve on the good in question and to look for substitutes. A rising relative price also, by increasing profit opportunities, entices producers to bring more of the good in question to market.
- ◆ In this way, relative-price changes transmit vital information necessary for the efficient allocation of resources throughout any market economy. Inflation, by contrast, contributes no information useful to our consumption, production, or labour choices.
- ◆ If anything, inflation can temporarily distort vital relative-price signals, leading people to make unsound economic choices. It can even cause people to shift their time and resources away from activities that foster production and long-term economic growth to activities intended to protect their wealth rather than expand it. (*Federal Reserve Bank of Cleveland*)
- ◆ Against this backdrop we calculated the relative prices of major groups/items as relative to overall CPI. And our results are startling. As per MOSPI the Apr'21 CPI eased to 4.29% as compared to 5.52% primarily due to significant deceleration in food prices. However, if we calculate the relative prices of food items compared to overall CPI we have seen that the deceleration was benign not sharp as it was seen in actual food CPI.
- ◆ Similarly, for certain items like fuel and health the increase in relative prices is maximum. Interestingly, the core CPI which was showing a decline of 57 bps has relatively increased by 18 points.

ARE APR'21 CPI NUMBERS RELIABLE?

- ◆ In normal course, MOSPI collects the price data from representative and selected 1114 urban markets and 1181 villages covering all States/UTs through personal visits by field staff of Field Operations Division of NSO on a weekly roster. However, during Apr'21, NSO collected prices from 99.1% villages and 97.4% urban markets while the Market-wise prices reported therein were 84.6% for rural and 87.4% for urban. During the month of Apr'21 most of the states imposed lockdown and almost all non-essential enterprises/markets were closed. Under such circumstances we are a little apprehensive that MOSPI was able to cover almost 97-99% markets. Hence we believe that Apr'21 CPI number could be an approximation at best as the last year's Apr-Jun numbers. One more factor that indicates that Apr-21 numbers are not worthy for consideration is the changing behavioural habits that is clearly impacting inflation numbers.

Item	Change in CPI Inflation vs Change in Relative Prices					
	CPI Inflation %			Relative Price compared to Overall CPI		
	Mar-21	Apr-21	Change	Mar-21	Apr-21	Change
Food and beverages	5.24	2.66	-2.58	0.95	0.62	-0.33
Cereals and products	-0.69	-2.96	-2.27	-0.12	-0.69	-0.56
Vegetables	-4.96	-14.18	-9.22	-0.90	-3.30	-2.40
Pulses and products	13.25	7.51	-5.74	2.40	1.75	-0.65
Sugar and confectionery	-0.53	-5.99	-5.46	-0.10	-1.39	-1.30
Pan, tobacco and intoxicants	9.87	9.01	-0.86	1.79	2.10	0.31
Clothing and footwear	4.41	3.49	-0.92	0.80	0.81	0.01
Clothing	4.37	3.52	-0.84	0.79	0.82	0.03
Footwear	4.23	3.19	-1.03	0.77	0.74	-0.02
Housing	3.50	3.73	0.23	0.63	0.87	0.23
Fuel and light	4.43	7.91	3.48	0.80	1.84	1.04
Miscellaneous	6.95	6.19	-0.77	1.26	1.44	0.18
Health	6.17	7.76	1.59	1.12	1.81	0.69
Transport and communication	12.55	11.04	-1.51	2.27	2.57	0.30
Personal care and effects	5.92	5.36	-0.57	1.07	1.25	0.17
Core CPI	6.00	5.43	-0.57	1.09	1.26	0.18
Services CPI	7.75	7.11	-0.64	1.40	1.66	0.25

NSO vis-à-vis SBI CPI Inflation (%)



Source: SBI Research

- ◆ Since the beginning of pandemic, the world has seen significant behavioural changes at all levels (Governments, Regulators, Individuals, etc.). India was also not an exception and had witnessed many behavioural changes of economic agents with initial lockdown and subsequent reopening of the economy in phases.
- ◆ Against this backdrop, we have re-estimated the CPI inflation since Apr'20 by using monthly credit card spends of SBI credit cards of a sufficiently large sample of customers on a recurring basis across all age groups gender-wise and spending that we assiduously bifurcated into non-discretionary and discretionary spends. We used changing weights for all the months starting from April. In principle, we followed the methodology by constructing a Covid-19 consumption basket for India and estimate CPI inflation again and using Pasche price index.

- ◆ Our results reveal 2 distinct trends. Firstly, the trends between Apr-Nov'20. In principle, the share of discretionary spending of consumers that had reached as much as 35% of total cards spending in February crashed to 16% in April. Since April, the share of discretionary spends has, however, fluctuated wildly between 15% and 35% indicating consumers are still uncertain when to splurge on items of discretionary consumption, as uncertainty has prevailed in the minds of consumers with different phases of economy opening.
- ◆ But the most definitive conclusion when we re-estimated CPI headline by using Paasche's Index, since Dec'20, our CPI computed inflation is higher than CSO estimate. This has happened as spend on oil in December **has crowded out the spending on other discretionary items, like health, grocery and utility services that was the trend in earlier months which is worrisome. In fact, the share of non discretionary spend has jumped to 59% in Apr'21 from 52% in March. In Apr & May 2020, the Non-discretionary share has reached 84%.**
- ◆ This demands urgent cut in oil prices through tax rationalization, otherwise consumers' non discretionary spending will continue to get distorted and crowd out discretionary expenses. This will also impart an upward bias in inflation.

IMPACT OF ONLINE PRICES ON HEADLINE CPI

- ◆ The Pandemic has also introduced an outlet bias, as a large share of total spending moved online that is charging a mark up over off line prices. For example, the use of online delivery platforms, such as Goffers, Nature Basket, Licious etc., has soared during the Pandemic. Most retailers in these platforms tend to have higher prices than in their physical stores. Since this is not accounted in the data collection methodology used by the NSO, the change in spending outlets could cause another downward bias in the headline CPI as computed by NSO. If NSO considers online prices, there would be 10/15 bps impact on CPI inflation.
- ◆ During this crisis, consumers have spent a lot of time at home and online – and have become comfortable doing a set of activities online. So, people are also shopping essential items from e-commerce platforms. Interestingly, before COVID-19, the prices of e-commerce outlets were much lower than the MRP. However, due to the rise in demand and less supply, now there is no/less bulk discounts in e-commerce. So, the price of e-commerce platforms and Kirana stores has converged.

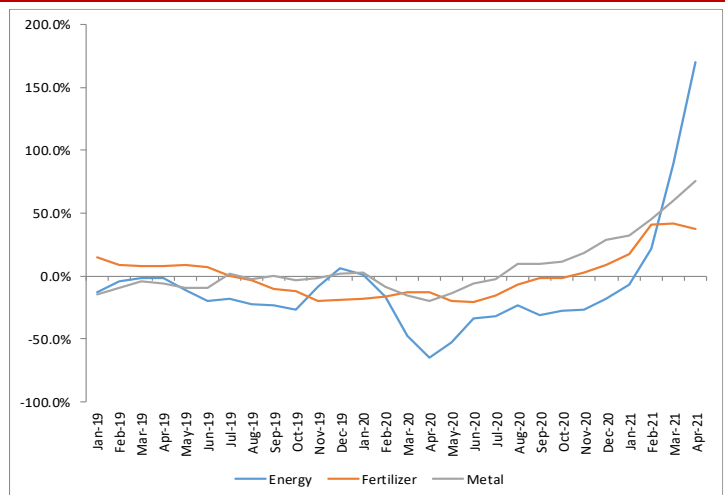
TRENDS IN INTERNATIONAL COMMODITY PRICES

- ◆ Food prices tracked by FAO Food Price Index (FFPI) averaged 120.9 points in April 2021, 1.7% higher than in March. The increase marked the eleventh consecutive monthly rise in the value of the FFPI to its highest level since May 2014. The April rise was led by strong increase in the prices of sugar, followed by oils, meat, dairy and cereals.
- ◆ The price of non-food items namely – energy, fertilizer and metals continue to rise. Most of the metal prices have crossed their pre-pandemic levels. Further, metal price shocks appear to have asymmetric impact, with price increases associated with small, temporary expansions in activity, but price declines associated with more pronounced growth slowdowns and fiscal and export revenue losses. These results highlight the importance of counter-cyclical policy measures when responding to commodity price changes.

FEDERAL RESERVE ACTION

- ◆ Rise in commodity prices have fuelled market expectation of possible rate hike by US Federal Reserve. US job openings surged in March to a record high, underscoring a rapid increase in labour demand as vaccinations accelerate and states reopen their economies. But companies appear unable to find the workers they need, hence vacancies were not filled. However, policy circles still maintain that current inflationary pressure in the US economy is transitory in nature and may not ultimately call for rate hike.

Trends in International Commodity Prices (y-o-y)



Source: SBI Research

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