

6. Time to Rationalize Fuel Taxes

Prelims Syllabus: Economy

Mains Syllabus: GS-III Inflation and Policy Response

Why in News?

- The disconnect between retail and wholesale inflation suggests that the two measures are driven by distinct and Unrelated Shocks.

The Disconnect between retail Inflation and Wholesale Inflation:

- In the months between April 2020 and November 2020, retail inflation remained above 6%, while average wholesale inflation was -0.20%.
- During the financial crisis (2008-2009) wholesale inflation came down significantly as commodity prices crashed after a boom, but retail inflation kept rising.
- **Correlation:** This disconnect is reflected in the Contemporaneous correlation between these two measures of inflation, which we find to be very low (0.04), and not significant.
- Understanding the reasons for the Disconnect
- We cannot rule out feedback from wholesale inflation to retail inflation.
- To better explore this, it helps to understand the driving forces behind retail and wholesale inflation.
- Driving factors for CPI: Retail inflation is closely linked to food and beverage prices, partly because of their higher weightage in the consumer price index (CPI).
- The dominance of supply shocks: High retail inflation in 2020 was primarily due to the rising prices of food and beverages.
- The surge was likely led by the usual supply shocks—rainfall, agricultural productivity, or Covid-19-induced supply shocks.
- This suggests two important features of Indian retail inflation: it is predominantly led by supply shocks (food inflation shock) and it is transitory in nature.
- Driving factor for WPI: High wholesale inflation in recent months was mainly due to rising prices in fuel and power and manufacturing, which together comprise around 77% of the wholesale price index (WPI).
- Rising fuel and energy prices in India were a result of the recent increase in global oil prices.

Takeaways:

- High wholesale inflation should not warrant any immediate policy responses as the two inflation measures seem to reflect Different Things.
- Overall, the high correlation between world energy inflation and India's wholesale inflation (0.88) Indicates that India's wholesale inflation is predominantly driven by world Commodity Prices.
- On the other hand, the low correlation between India's retail inflation and world energy Inflation (-0.13, and not significant), suggests that India's retail inflation is primarily driven by domestic food prices.
- Higher wholesale inflation implies a higher profit margin for producers, which acts as an incentive for Investment
- There are, in fact, some early signs of a revival in investment in recent quarters, and policy must be careful not to Derail this.

Policy Options:

- Given the pass-through of wholesale inflation into retail inflation, if the ongoing commodity boom persists, then the fuel and power component of the WPI is likely to raise retail inflation directly.
- At that point, there would be some urgency to increase the interest rate, which may be premature and could dampen the revival of growth prospects.
- To avoid the interest rate response, the best option going forward would be to rationalise fuel taxes, to reduce the pass-through of global commodity prices into wholesale prices and ultimately into retail inflation.