Edelweiss
Ideas create, values protect

INFLATION

Journey beyond 'ground zero'

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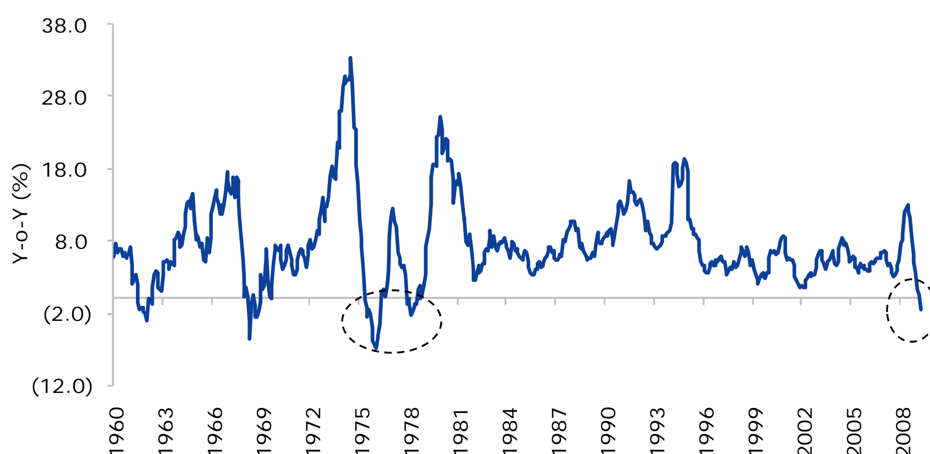
Inflation goes negative ....

The Wholesale Price Index (WPI)-based inflation for the week-ended June 6 came in at -1.61% Y-o-Y, in line with expectations (Edelweiss and consensus: -1.52%). The sharp fall in headline inflation in the current week largely reflect the base effect of the spike in WPI in June 2008 owing sharp upward revision in administered fuel prices.

Y-o-Y, WPI inflation has been negative only four times in the last 50 years, with the spells lasting for 6-12 months in most of the cases. The last spell of negative inflation came in 1975-76, following the global oil crisis, and lasted for ~12 months.



This time, WPI inflation is likely to remain negative (Y-o-Y) for the next two-four months. The lowest point of WPI inflation could be around -2%. The trajectory of a rapid fall in inflation, from Q3FY09 to below zero by mid-2009, had been exactly on expected lines (refer our note, '*Inflation: From dizzying heights to ground zero',* dated November 04, 2008).

.... but, faces strong upside risks over medium term ....

However, continued high global liquidity infusion and possibility of greater pass-through of oil and commodity prices may significantly push inflation beyond the current expectation over the next 9-12 months. Food prices have been continuously on the rise, as reflected in the high CPI level. We see a possibility of WPI inflation reaching 6-7% with an upside risk by March 2010 and also acknowledge the possibility of it touching double-digits again in FY11.

.... putting central banks in a fix

Possibilities of such overheating in prices, despite a global slowdown, have put policy makers across the globe in a fix. While central banks globally need to embrace an easy money policy to support real economic activities at the moment, they also need to put in place a timely, smooth and systematic exit from the ongoing monetary easing. Premature monetary tightening may increase the risk of a prolonged slowdown, while delayed tightening could increase future inflationary pressure. Major global economies may have to resort to coordinated monetary efforts again for achieving a fine balance on this issue over the next 6-12 months.