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Subir Gokarn: Tomato pickle

Subir Gokarn | New Delhi July 03, 2006 Last Updated at 00:00 IST

The best prophylactic against surges in the prices of fresh produce is ensuring processed equivalents become affordable.

In July 2004, the inflation rate, as measured by the wholesale price index, shot beyond the 8 per cent mark, reviving a spectre that had been long since presumed dead. Rising oil prices in the aftermath of the Iraq conflict were largely responsible for this spike, which moderated considerably in the following weeks. In October 2004, the Reserve Bank of India (RBI) raised its benchmark interest rate for the first time in more than three years.

For the last year and a half, wholesale inflation has tested the 5.5 per cent mark but not seriously threatened it. Nevertheless, inflation has emerged as the dominant macroeconomic concern, with the RBI having raised interest rates several times, including twice during 2006. It believes that the reported rate of inflation understates the problem because the government has not fully passed on the impact of oil price increases.

The sharp focus on inflation represents a dramatic change in the macroeconomic environment and, consequently, our expectations of how policy will be conducted in the short to medium term. Of course, this is very much a global phenomenon, with central banks in all major economies persistently increasing interest rates. China is the only notable exception.

However, in the Indian context, the oil price-driven impetus was exacerbated in the last few weeks by sharp spikes in the prices of two important food articles, pulses and vegetables. Perceptions of what the "true" rate of inflation is have been influenced by dramatic increases in the prices of moong dal and tomatoes, in particular, although several other items are also on the radar screen. The political rhetoric emerging against the government really takes us back a long time. The last time I remember this kind of confrontation emerging was the 1998 onion crisis. Has the economy been running harder and harder all this time, only to find itself still in the same place on this issue?

There are both negative and positive responses to that question. But, before getting to those, let's look at how inflation is measured. Prices of goods and services increase for two kinds of reasons. The first (macroeconomic) is because of an underlying inflationary trend in the economy, which more impacts all prices more or less similarly. The classic driver of this is an accelerating supply of money, but the increase in the price of a universal input like energy could also have a similar impact.

The second (microeconomic) is due to sector-specific factors, essentially the mismatch between demand and supply of individual commodities. In a supply-constrained situation, the prices of a particular commodity can increase sharply, as we saw with onions in 1998, and tomatoes and moong dal, among others recently.

The problem is that any inflation measurement system, such as the wholesale price index, finds it difficult to differentiate between the two. If pulses and vegetables have sufficient weightings in the commodity basket that makes up the index, microeconomic forces that drive up their prices will register as an increase in the overall rate of inflation, which, conceptually, is a macroeconomic phenomenon.

Central banks need an accurate measure of macroeconomic inflation on which to base their policy responses. They typically develop concepts like "core inflation", which calculate the index omitting food and energy items.

Just to put this in perspective, over the last few weeks, this measure for India would suggest an inflation rate of around 3 per cent per year, because prices of manufactured goods, in general, are increasing very moderately.

But, that is neither here nor there. Since oil prices are such an important driver of inflation today, leaving them out of policy consideration obviously does not make sense. And, if that is so, who is to say that pulses and vegetables should be left of consideration?

The point is that the policy response has to be based on correct understanding of the cause. Monetary policy, by its very nature, cannot address inflationary pressures that arise from supply-demand mismatches in individual commodities. Even as it addresses the macroeconomic consequences of rising oil prices, it needs to be supplemented by measures that deal with such mismatches.

In the specific context of vegetables, I was struck by a news story on tomato prices, broadcast by a television channel, in which members of a family were interviewed about their tomato-less existence. They were all appropriately downcast about prices having reached Rs 36 per kg, but what interested me most was the statement that they would have no option but to use packaged tomato puree as a substitute.

Does tomato puree become economical only when the price of fresh tomatoes reaches Rs 36 per kg? Only in India. As a consequence of a rather unfortunate series of distortions and system inadequacies, we find ourselves in a situation in which fresh produce is cheaper than its processed and preserved equivalent. The whole point of preserved food is that its ingredients can be procured at low prices and given an extended shelf life. Price-conscious consumers would be substituting between fresh and processed produce the minute seasons changed and the prices of fresh produce began to rise.

That this pattern of substitution has not emerged with any significance in India reflects on how expensive it is to process food here. It is often said that only 2 per cent of our production of fruits and vegetables is processed. This itself is a consequence of high processing costs that make processed food a "premium" commodity, rather than an item of everyday consumption, making potentially expensive ingredients accessible to larger and larger numbers of consumers.

People who have made it a habit to use tomato puree as a matter or routine would not be so traumatised by skyrocketing tomato prices; in fact, over time, effective supply chain management would reduce the probability of such spikes. But for this to happen, tomato puree has to cost much less than it does today. And here we come right back to familiar issues""rural infrastructure, cold chains, organised and large-scale retail and small-scale reservation.

The best way to protect people against surges in the prices of fresh produce, which could happen at any time, is ensuring that processed equivalents become increasingly affordable. Unfortunately, our food economy is characterised by a bizarre equilibrium in which fresh produce is consumed by lower-income segments because processed and preserved foods are beyond their affordability and lie entirely in the domain of the affluent.

The author is chief economist, Crisil. The views here are personal