INFLATION IN INDIA

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After India's GDP growth rate picked up significantly from 2003 onwards, the country also succeeded in achieving fiscal consolidation, with the fiscal deficit falling between 2003 and 2007 (both the Centre and States), thanks partly to the Fiscal Responsibility Budget Management Act (FRBM, 2003). However, the global financial crisis starting from 2008 led to a very sharp increase in public expenditure, by way of a counter-cyclical fiscal stimulus to the economy, which succeeded in its objective of sustaining growth all the way up to 2010-11. However, a combination of the increase in public spending and output supply side constraints resulted in an inflation rate well above what Indian policy makers (always sensitive to the concerns of the poor) had become used to, i.e. an inflation rate of 5-6 per cent per annum. Since 2010 the inflation rate of the Indian economy, especially fuelled by food inflation well above the average inflation rate, has been much higher than the normally expected rate of 5 to 6 per cent.

The Reserve Bank of India responded by raising lending rates with a view to containing inflation; these rates have remained constantly high since 2010. The RBI's inflation targeting, however, had only limited impact, and the inflation rate has barely crawled downwards. In other words, many would argue (as industry has constantly done) that RBI's inflation targeting and tight monetary policy have not been working, while at the same time impacting growth adversely. The RBI, on its part, has responded by noting that as long as the fiscal deficit which has more than doubled for the Central Government between 2007-08 and 2011-12, remains as high as it is now, it is difficult for the RBI to reduce interest rates. At the same time, the international economic environment has only worsened; commodity prices, especially for oil, have remained high and India imports 80 per cent of its crude oil needs. While growth cannot be sacrificed, India remains unique among large emerging market economies in suffering from consistently higher than normal inflation for the last few years. Thus, India's policy makers have been caught between a rock and a hard place.

Inflation management is one of the hardest tasks an economic policymaker has to undertake. It appears, at first sight, that one can rely entirely on commonsense to carry out this task. But that will be a cardinal mistake. While inflation policy does require judgment and intuition, it is essential that these be backed up with statistical information and an understanding of economic theory. This paper tries to bring together the formal analytics that underlie inflation policy.

Inflation is, at the same time, one of the most dreaded and one of the most misunderstood of economic phenomena. We know from experience, combined with cogitation, that the prices of commodities will, over time, rise and fall, responding to the pulls and pushes of demand and supply. A failure of a particular crop or a flash fashion for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected glut in the production of onions will cause the price of onions to fall. These price movements are nature's way of signaling to consumers that they should consume less of the commodity facing shortage and more of the good in glut and to producers to produce more of what is in short supply and less of what is available in plenty. To even out these ebbs and flows of prices would be folly, as we know from countless examples of misdirected government interventions. Inflation, on the other hand, has little to do with these changes in relative prices of goods and services. It refers, instead, to a sustained rise in prices across the board, that is, a phenomenon where the average price of all goods is on an increasing trajectory for some stretch of time. Of course, this may be accompanied by changes in relative prices. For the common person, there is something threatening about the phenomenon of inflation, especially on those occasions when the rise in prices of goods is not matched by an equivalent increase in the price of labour.

Inflation has been with humankind ever since we moved away from barter to the use of mediums of exchange, like paper money, precious metals or even cigarettes, as happened in a prisoners of war camp during the Second World War (Radford, 1945). While it is true that we do not fully understand inflation and, to that extent it remains a threat, what is comforting is that years of data collection and theoretical research have given us deep insights into this troubling phenomenon. And even though we do not fully understand its origins, as in the case of the emperor of maladies, we have developed techniques and policy interventions that can control it. For some of these antidotes, there is good reason to be cautious when using them and in deciding what dose to administer, since each such policy intervention comes with side effects. But it is a testimony to the advance of economics as science that the spiraling hyperinflations that occurred ever so often till even half a century ago, now seem to be a matter of history.

India is right now in the midst of an inflationary episode that has gone on for 17 months. It began in December 2009, when the WPI inflation climbed to 7.15%1, it continued to rise, peaked in April 2010, at just short of 11%. Thereafter, it has been on a broadly downward trajectory. What has caused some concern once again is that there was a small pick-up in inflation in December 2011 and also because the downward trajectory has been disappointingly slow. Before this 17-month run, we had one year of negligible inflation; but just prior to that there was another rally from March 2008 to December 2008, when WPI inflation hovered in and around 10%. Before these two rallies in quick succession, India had very little inflation for a dozen years. There were occasional months when inflation would exceed 8% and not a single month when it was in double digits during these twelve years of relative price stability.

For reasons of completeness it may be mentioned that independent India’s highest inflation occurred in September 1974, when inflation reached 33.3%. Arguably our worst inflationary episode was from November 1973 to December 1974, when inflation never dropped below 20% and was above 30% for four consecutive months starting June 1974. Comparable inflations have occurred in Russia from December 1921 to January 1924, in Greece in 1943, in Zimbabwe in 2008, in Germany in 1923 and in many other instances. The German hyperinflation of 1923 may well be the most analyzed and diagnosed inflation. It played havoc with the economy, created political tensions which contributed to the rise of Nazism, and also caused psychological disturbances. Doctors in Germany in 1923 identified a mental illness called “cipher stroke” which many people were afflicted with during the height of the hyperinflation.

A study of the Brazilian economy, since 1962, shows that the nation did not have a single year where inflation was in single digits from 1962 to 1997. There were only two years (1973 and 1974) when inflation was below 20%. The real bad period was 1988 to 1994. Prices were rising on average close to 2000% per annum during this time. Brazil’s experience gives us a bit of an insight into what inflation does to growth. A pure eyeballing of the data suggests that, when inflation is below ten percent, there is little correlation between the rate of inflation and the growth rate. But at higher levels, inflation is usually associated with lower growth; and especially when inflation, starting at a high level rises even further, growth slows down. During the six hyperinflationary years mentioned above, growth had a real set-back with GDP growing at negative rates in three out of those six years. All this is not to deny that there are examples of nations sustaining over 10% inflation with very high growth over multiple years.

Asian countries have in general had more stable prices. South Korea, which grew at astonishingly high rates from the late 1960s to recently, did have high inflation but nowhere near the experience of Latin American economies like Brazil. The average inflation in South Korea in the 1970s was in double digits, with inflation peaking in 1980. While this coincided with high growth for quite some time, it eventually seemed to have had a restraining effect on GDP growth. Tighter monetary and fiscal measures brought inflation down in the 1980s and, eventually, restored high growth This wide range of experience from around the world and prodigious amounts of research have vastly enhanced our understanding of inflation. The relatively good inflation record among all industrialized nations and emerging market economies over the last two decades is testimony to this. However, this experience has also taught us that there is a lot that we do not understand and that the drivers of inflation, like bird flu, can change over time rendering standard antidotes less effective and calling for fresh research and, maybe, new medicines.

Since these endogenous features of the economy can vary from one country to another, this calls for independent research in each nation. Over the last few years there is a sense that the inflation faced by emerging economies is changing some of its stripes, thereby demanding not just greater resolve but new ideas in order to have price stability. Rakshit (2011) points to the somewhat unusual divergence between CPI inflation and WPI inflation in recent times, even though it should be pointed out that the two have converged once again over the last six months.

For years, the US Fed kept a control on prices by buying and selling government bonds which was the other side of, respectively, releasing money into and absorbing money from the economy. However, money is not the only medium of exchange. There are ‘near monies’ that can do some of the work for money. People can use all kinds of other commodities and papers to trade goods. If, for instance, government bonds were fully acceptable as a medium of exchange, then the central bank selling bonds and collecting money would have very little impact on the economy. It is the appearance of 'near monies' that has compelled the US Fed to change some of its strategies for maintaining stable prices.

Studies show that an astonishingly high fraction of the grain meant to be given to the poor and vulnerable through our Public Distribution System (PDS) get diverted, presumably sold off at illegal high prices or wasted. According to a study by Khera (2010), in 2001-02, 39% of foodgrain meant to reach the poor through India's PDS was lost to leakage and diversion. A more recent study by her (Khera, 2011; see also Jha and Ramaswamy, 2010) shows that the problem has got worse. In 2007-08, the diversion of foodgrain was at 43.9%. It had risen to as high as 54% in 2004-05. This disappointing story is mirrored in the fact that only a fraction of the poor get their food from PDS stores. In 2004-05 only 17% of the poorest quintile households received food from PDS stores. And for some poor states, such as Bihar and UP this figure is as low as 2% and 6% respectively (Parikh, 2011). Clearly, this is unacceptable, since it tends to bloat fiscal expenditure, causing inflation across the board. We have to think of a major overhaul of our public distribution system and give subsidies, as far as possible, by making direct transfers to the poor, who should then be allowed to buy their food from any store, private and public. Fortunately, the government has taken steps to move towards a major overhaul, with the announcement in the Union Budget, presented in February 2011, that we will move over to direct transfers to a targeted population, in lieu of the earlier system of trying to deliver subsidized for kerosene, LPG and fertilizers to all. There has also been some discussion in government arguing that improving supply chain management through modern retailing can help cut down the gap between farm gate price and retail price but there are also some voices of dissent on this.

It is widely believed and is arguably true that when a well-informed responsible government or quasi-government agency makes an inflation forecast that, in itself, can cause the course of inflation in the future to change. This is because, at least in the short run, the actual inflation rate depends, in part, on what people expect the inflation rate to be. Inflation can get worsened by the very fact of higher inflationary expectations and likewise prices can be stabilized, to a certain extent by virtue of leading people to expect that prices will be stable. Thus, we often hear about how a policymaker stoked inflation by saying in public that inflation will go up. Usually, behind such an observation is the critique that no one should be so irresponsible as to fuel inflation by making such statements. But this immediately places the Central Bank and the Treasury in a dilemma that Ahamed (2009) alludes to and may be logically impossible to resolve.

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