Inflation In India- Policy Perspective

For any economy, both low inflation and robust growth are essential to improve economic welfare. Fiscal policy also has a major role in inflation management both in terms of containing government demand in the short run and augmenting the supply situations in the medium term. The effectiveness of monetary policy improves in a supportive fiscal environment.

Recently inflation becomes major policy challenge in India. The reasons for this high inflation are following

1. The growing demand supply imbalance, more so in protein based food items.
2. Significant increases in rural wages, particularly in the post MGNREGA period
3. Large increase in minimum support prices
4. High global food prices
5. Rigidity in supply chain
6. Exchange rate depreciation

The inflation process thus started from primary food and fuel, and these two together accounts for as high as 29% of total weights in WPI. The increase in these prices spills over to non-food and non-fuel (or the core) inflation through both higher input costs and higher inflation expectations getting reflected in wage revisions. In the presence of strong demand conditions, the spillover could be faster, to cause a generalized inflationary process.

In 2011-12, RBI raised its policy rate 13 times when much of the inflationary pressures are from food and fuel. It is correct to say that food inflation cannot decline because of higher policy rates but the ratinal for monetary policy action has to be seen from two major standpoints

1. A generalized inflation process cannot persist in the absence of aggregate demand and hence, if monetary policy succeeds in containing aggregate demand, that could help in softening inflation.
2. Even when monetary policy cannot address food and fuel inflation directly, it can certainly prevent inflationary expectations getting worse under the influence of high food and fuel inflation.

The effectiveness of monetary policy depends on structure of economy and the level of development of the financial sector.

The composition of aggregate demand would broadly suggest three types of demand, i.e. government demand, private consumption demand and private investment demand. Government demand is generally not very sensitive to higher policy rates. Private consumption demand in India also is not financed by credit to the extent we see in advanced economies. Hence, private consumption demand may also not be very sensitive to higher interest rates. Private investment demand, however, may be relatively more sensitive to higher policy rates, and slowdown in investment demand has implications in terms of growth sacrifice. Empirical estimates for India suggest that India's threshold inflation could be in the

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range of 4 to 6 per cent, and inflation levels exceeding the threshold on a sustained basis is harmful to growth. Thus, anti-inflationary increases in policy rates may look anti-growth in the short-run, but such a policy stance is necessary for achieving low inflation and high growth objective in the medium run. Since monetary policy operates with a lag, it is this medium-term goal of non-inflationary high growth that explains the Reserve Bank's monetary policy actions taken so far.

Level of development of the financial sector is important for transmission of monetary policy actions. Large informal sector with limited access to formal finance could dampen monetary policy transmission.

The better coordination between monetary and fiscal policy is must to achieve desired objectives. In India, despite higher deficit levels since the global crisis, the debt levels as % of GDP have not increased. In fact liabilities (centre + state) have declined from 71.4% in 2007-08 to 64.3 % in 2010-11.

New level of inflation- debate

The average inflation rate of 3 years (sept 2005- August 2008) was 6.0%, which increased to 8.8% for February 2010 – January 2013. By using this empirical evidence, New Normal Hypothesis (NNH) suggests that Indian Inflation rate has undergone an upward phase shift owing to domestic and global developments. Monetary policy calibration, it argued can get flawed unless the RBI acknowledges this new normal.

Arguments in support of a NNH

1. Wage Price spiral is a permanent shock to the inflation path-
   As wages increases, the cost of production will increase in the absence of productivity gain. If rise in wages is due to exogenous factors then it will raise price level.
   a. the large public employment programme has not only pushed up wages, but also exerted upward pressure on agricultural input prices and thereby on food prices.
   b. even as wages have increased, there has been no corresponding increase in productivity – a recipe for inflation.

   NNH also argues that it will be politically difficult to reverse these entitlement programmes, they are here to stay, and that India should accept wage price pressures as a structural feature and adjusts its inflation goal accordingly.

2. Commodity price pressures will persist
   Recently the average price of Indian basket crude oil has increased significantly. From $70 per Barrel to $110 per barrel between 2009-10 and 2011-12. This increased in oil price was against the expectations. The reasons for this hike in oil prices were followings
   a. Oil supplier calibrated supply to ensure a minimum floor price for crude

b. Financialisation of commodities – this creates an asymmetry between financial market conditions and the real economy that will remain a structural features of the global economy.
c. Due to rise in population, energy consumption etc.

The NNH argues in this context that these global price pressures will transmit to Indian prices either because of actual imports or because of largely import party pricing thereby stoking inflation pressures.

3. The positive supply shock of the great moderation has run out-
As china is rebalancing its growth strategy by focusing more on domestic market from export market, the supply of cheap goods from china will decline in coming days. In this context, NNH argument is follows
Because the positive supply shock from China has all but waned, global inflation will shift to a new normal once the recovery is complete. The Reserve Bank's implicit formula is to calibrate its comfort level of inflation some 2-3 percentage points above the average rate of inflation in advanced economies, while also aiming to converge to the world average inflation in the medium-term. If so, it should recognise the new global normal for inflation and recalibrate its comfort level for domestic infl ation accordingly.

4. QE will lead to higher inflation in Advanced Economies

5. India should exploit the positive relationship suggested by the Phillips curve

6. PPP convergence on account of India's integration into the global economy will imply accepting a new normal for inflation.
This argument is based on the Balassa-Samuelson effect which says that the absolute price level in a developing economy needs to converge with those of developed economies as it integrates into the global economy on account of 'PPP' (purchasing power parity) catch up. In the process of this catch-up, wages may increase ahead of productivity levels, especially in the non-tradeable sector, leading to inflation.

Arguments against

1. Wage price spiral cannot sustain indefinitely- like any other supply shock, exogenously imposed higher wages can be inflationary in the first round, but the bargaining power of labour will erode in tie, and the necessary adjustment will take place to bring wages back in the line with productivity levels.
The recent high growth in rural wages also reflects a catch up with minimum wages, a necessary adjustment intended by the Government. After the initial catch-up, however, wage growth cannot be sustained without corresponding productivity increases. If not, firms will gradually lose their

power to translate higher input prices to higher output prices, inevitably leading to a correction in the wage pressures.

Furthermore, we must recognize that the Government does not have the fiscal capacity to continue entitlements and welfare programmes at this level. The Government's embrace fiscal responsibility will act as a self-limiting check on the wage-price spiral.

2. Commodity price-shocks are unlikely to persist

   The commodity prices will decline mainly on account of alternative energy scenario going forward. The global energy scenario will change on three dimensions

   a. Efficency- regulator and competitive pressure will ensure that gains from energy efficiency will continue to roll in, possibly at an accelerated pace.
   b. Demand- now countries are moving towards less energy intensive development path, eg china will do so by 2020
   c. Supply- shale production, renewable source of energy

   But the gains on the energy front will translate to gains on the inflation front only if other policies are managed intelligently- urbanization, agriculture development

3. China is changing its strategy of development from export orientation to import orientation. But this will happen gradually. So at least for next decade, china will remain the dominant supplier of cheap product in the world market, so inflation will be under check.
4. In USA, long run price expectation do not suggest any risk to price stability. The Fed also repeatedly asserted that they have in place well thought through plans to unwind QE in a non inflationary way. The political economy compulsions will therefore ensure that governments do not resort to inflating their way out of debt.
5. The Phillips curve relationship does not provide a realistic policy option-
6. New normal on account of PPP convergence is not inevitable- Apart from all the empirical arguments, there is also an important conceptual argument against the 'new normal' hypothesis. As India's integration with the world picks up pace over the next decade, it is important also that our inflation rate is in line with global inflation. A new normal based entirely on domestic considerations will result in a permanent wedge between domestic and global inflation which means a persistent real appreciation of currency. Real appreciation is unambiguously contractionary and militates against our growth aspiration. To support sustainable growth during a period when the economy is globalising, our inflation rate needs to converge with the global inflation rate. This is the rationale behind the Reserve Bank's policy of calibrating its medium term inflation goal to global inflation.

   RBI's view on this is that

   a. PPP convergence cannot be a policy goal, and accepting higher inflation to aid PPP catch up will be both futile and indefensible. As India's per capita income rises, PPP convergence will happen automatically. We need to make sure that rise in incomes is

accompanied by productivity gains so that the process of PPP catch up is non-inflationary.

b. To support sustainable growth during a period when the economy is globalising, our inflation rate needs to converge with the global inflation rate. We need to manage this convergence by calibrating the 'inflation differential' over time rather than acquiescing in a new normal for inflation.

c. There is also no a priori reason to believe that the entire burden of adjustment on account of integration with the global economy will have to come by way of the price differential closing. Part, if not all, of the burden can be borne by exchange rate adjustment too

Conclusion

Admittedly, the average inflation rate in India over the last three years has trended up. Nevertheless, the context presents neither a necessary nor a sufficient condition for the Reserve Bank to revise its inflation goal. Not a necessary condition because, as indicated earlier, much of our inflation is driven by supply constraints which can be corrected by appropriate policies and their effective implementation. Accepting a new normal for inflation not only has no theoretical or empirical support, but entails the moral hazard of policy inaction in dealing with supply constraints. Not a sufficient condition because there is no empirical evidence to establish that the benefits of higher growth outweigh the costs of welfare loss associated with higher inflation.

Key to our collective national aspiration for sustained high economic growth is low and steady inflation. It is only under such an environment of price stability that investors and consumers can make informed choices and contribute to growth. The responsibility of the Reserve Bank in this regard is to anchor inflation expectations and ensure price stability. Neither theory nor empirical evidence presents a credible case for acquiescing in a new normal for inflation in India.

Why is it important to recognize if there is a new normal for inflation?

Suppose RBI ignores the new normal for inflation if NNH is true then it will have following consequences

1. It will lead to a flawed monetary policy stance with potentially heavy macroeconomic costs

Various concepts used

Balassa Samuelson Effect

Frictionless, perfectly competitive traded-goods markets justify thinking of purchasing power parity (PPP) as the main driver of exchange rates in the long-run. But differences in the traded/non-traded sectors of economies tend to be persistent and affect movements in local price levels in ways that upset the PPP balance.

Balassa Samuelson Effect

The Balassa Samuelson Effect explains differences in real exchange rate movements in terms of productivity differences. In particular, it explains why catching up countries tend to experience heavy pressure in favour of a real appreciation.

The real exchange rate (Q) is defined by:

$$Q = \frac{E.P^*}{P}$$

where E is the nominal exchange rate, P and P*respectively the domestic and foreign price indexes. By indicating respectively by T and N the variables concerning the tradable and non-tradable goods sectors, we can rewrite

$$P = (P_T)^{\alpha} (P_N)^{1-\alpha}$$

$$P^* = (P^*_T)^{\beta} (P^*_N)^{1-\beta}$$

where α is the weight of the domestic country's tradable goods sector, and β is the weight of the foreign country's tradable goods sector.

We can then rewrite the real exchange rate as

$$Q = \left(\frac{E.P_T^*}{P_T}\right)\left(\frac{(P_N^* / P_T^*)^{1-\beta}}{(P_N / P_T)^{1-\alpha}}\right)$$

In a catching up economy exposed to international competition, productivity in the tradable goods sector tends to rise faster on average than in the non-tradable good sector. All wages in the economy need to adjust to this increase, pushing up the cost of labor in the non-tradable goods sector relative to the sector's productivity. Therefore

P_N / P_T increases then Real exchange rate appreciation (Q declines) will take place

Dutch disease

In economics, the Dutch disease is the apparent relationship between the increase in exploitation of natural resources and a decline in the manufacturing sector (or agriculture). The mechanism is that an increase in revenues from natural resources (or inflows of foreign aid) will make a given nation's currency stronger compared to that of other nations (manifest in an exchange rate), resulting in the nation's other exports becoming more expensive for other countries to buy, making the manufacturing sector less competitive. While it most often refers to natural resource discovery, it can also refer to "any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance, and foreign direct investment".

The term was coined in 1977 by The Economist to describe the decline of the manufacturing sector in the Netherlands after the discovery of a large natural gas field in 1959.

Financialisation of commodities

The basic theory of price formation tells us how the price of a particular asset will change based on the adjustment to its supply and demand. However, values of assets are also determined by other business fundamentals, company's and world events, human psychology, and investors' belief about the possible future profit. In recent history that lead to an increase of individual and institutional investors' interest in allocating their resources in commodity markets. With a large in-flow of capital commodities' prices started to rise making them attractive components to effective investment portfolios.

So "Financialisation of commodities" is catch term used to describe a spike in commodity prices quite unrelated to fundamentals that gathered momentum in advance economies to here to stay.