

Inflation: A heretic's views

It was a pleasant surprise that, despite the rise in headline inflation, the central bank did not increase interest rates as most were expecting. This hopefully suggests a more measured, less “knee jerk”, reaction which is welcome. The second was the change in the incumbency of the Ministry for Environment and Forests. It is difficult to say whether the floating exchange rate policy, or the environmental regulation and judicial pronouncements, have damaged growth more under UPA II.

As for inflation, in the late 18th century, the Reverend Thomas Malthus believed that, since food supply is fixed, when population rises, wages will fall; the poor will no longer be able to afford enough food; their average life span would come down; they may be forced to stop reproducing; and the balance between demand for and supply of food will be restored. (It was this specter which persuaded Thomas Carlyle to describe economics as that “dismal science”.) Yes, markets are self-correcting; meanwhile, much of the cost of that correction falls on those least able to bear it!

On the history of inflation, “*median inflation rates before World War I were well below those of the more recent period: 0.5% p.a. for 1500-1799 and 0.71% for 1800-1913, in contrast with 5.0% for 1914-2006 much lower inflation rates could be quite shocking and traumatic to an economy*” (Reinhart and Rogoff *This Time is Different*). Clearly inflation seems to have gone up sharply over the last hundred years which, incidentally, coincides with modern, post-gold standard, central banking.

The above periods of low and high inflation correlate strongly with global population growth and its impact on the demographic profile: last year, the Japanese central bank governor had attributed Japan's deflation to the latter. One has not seen any formal studies on the subject but, on first principles, it stands to reason that the needs of goods and services of the young are, in general, much more than those of the old. India has the youngest population and the highest inflation rate among major economies. Is this mere correlation or cause and effect as well?

Milton Friedman has argued that “*Inflation is always and everywhere a monetary phenomenon*”. (Incidentally, he also believed that speculators always arbitrage between market prices and intrinsic values: the reality is that too many speculative strategies are momentum based, driving prices further away from intrinsic values!) The quantity theory of money is logical if we assume that the velocity of circulation of money is stable: then prices will rise with money supply. There are two major question marks:

- Is the assumption valid irrespective of the demographic profile of an economy; and
- The problems in measuring the quantity of money.

Apart from the usual M1, M2, and M3, Charles Kindleberger in his *Manias, Panics and Crashes* refers to analysts who have gone as high as M7 as measures of the quantity! The various M's rarely change in tandem and it is a moot factor which M determines inflation. I have also not understood why undrawn limits, whether on credit cards or overdrafts/cash credits, find no place in the calculation. Surely, these are as much “money” as the balance in demand deposits? This issue has puzzled me since long: I was about to conclude that my question must be foolish, until I found Gary Gorton of the Yale School of Management raising a similar issue in his *Misunderstanding Financial Crises* (1912) in relation to money market funds against which investors can issue cheques.

But to come back, given the difficulties with the M's, changes in short term interest rates became the accepted way of controlling inflation; now, of course, it is changing “inflation expectations”. I am puzzled how these can be altered by ¼ % changes in interest rates, if the *homo economicus* has rational expectations as all macroeconomic models assume. The most successful example of bringing inflation down by monetary policy is what Paul Volcker did in the late 1970s. Interest rates shot up (LIBOR more than 20% p.a.!) leading to recession and unemployment in the US, and an external debt crisis in many Latin American and African Countries. (The Bank of Canada's experience in the early 1990s was no different: inflation fell, but unemployment crossed 11%!) The people who lost jobs suffered most, but at least they got unemployment benefits.

Is inflation necessarily “bad” for the Indian economy? And, what is the threshold beyond which it becomes so? RBI research suggests that wholesale price inflation beyond 5/6% reduces growth. One has several reservations about the methodology used (missing variables, for one). It is also supposed to hurt the poor most: but surely the answer depends on how the question is

framed? The poor would surely prefer 2% inflation to 10%. But what if the question is whether they would prefer a steady job with 10% inflation or no job and 2% inflation? Let us not forget that there is a trade-off between inflation and employment (the Philips curve) – at least within limits!

As for food inflation, my heretical view is that it is perhaps the most painless way of transferring income from the non-agricultural to the agricultural economy where the per capita incomes are much lower -- thanks also to export restrictions, the anti GM-seed bias, the archaic and costly distribution system from the producer to the consumer, etc.!

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