Inflation, growth, money supply: some issues

Now that the uncertainty about likely monetary steps is over, it is perhaps time to ponder over some more basic issues. One fundamental, if often un-stated, assumption underlying any discussion of the subject is that inflation is bad, particularly for the poor. Globally, an interesting fact is that the strongest inflation hawks are often in the editorial pages of market fundamentalist publications like The Wall Street Journal and The Economist, not particularly noted for their concern for the poor. They also generally believe in the efficiency of markets and the rational expectations of economic agents resulting in pricing assts correctly, more generally in *laissez faire* policies: this belief also extends to the external value of a currency, but not to its domestic value which is supposed to be kept stable by "manipulation" of money supply and/or interest rates. One wonders to what extent this stance is the result of their anxiety to protect the purchasing power of the savings of the rich. One traditional inflation hawk, the IMF, seems to be defecting from the ranks: in a co-authored paper, Olivier Blanchard, its chief economist, recently argued that inflation targeting central banks should double the target to 4% so that they have enough room to ease interest rates at the time of banking crises or recession!

The standard argument is that inflation is "good" for long term growth. One wonders to what extent this view is still influenced by the 1920s hyperinflation in Germany, and the stagflation in much of the Western world in the 1970s, after the sharp hike in oil prices. It is true of course that excessive increase I money supply (1920s Germany, some Latin American countries of yesteryear, or today's Zimbabwe) can inflict enormous miseries on the people. At the other end is modern Japan with practically zero growth over two decades, and falling prices and nominal GDP, despite excessively loose monetary and fiscal polices, which clearly overturns all the conventional wisdom of macro-economics: are Keynes' "animal spirits" missing? Globalisation and ever-changing, market-determined exchange rates have added another dimension to the domestic variables. An equally interesting puzzle for me is how Asian countries like China and Korea have far larger monetary aggregates as a proportion of nominal GDP than ours, but a consistently lower inflation rate since a long time.

Western economists have coined an acronym called NAIRU for the desired level of unemployment: the non-accelerating inflation rate of unemployment. The idea is that a certain minimum unemployment is necessary if inflation is to remain low and stable. In other words, policy should be aimed, not at full employment, but keeping a few millions unemployed, for the benefit of the rest of us. Higher inflation, growth and job creation would actually help the poorest in these countries. What we need is not NAIRU but GMROI, a growth maximising rate of inflation on a 10-year time horizon.

Tighter monetary policy is supposed to reduce inflation by curtailing demand, by "cooling" an overheated economy. But higher interest rates may well lead to lower investment, growth and jobs: and for extended times. In India, growth came down sharply for about 5 years after the tight money and high interest rates of 1995-96. In the U.S., the extremely high rates of 1979 led to a few years of recession in that country itself, and in large parts of the world, and a debt crisis in much of Latin America and Africa. Surely, a poor person would prefer a Rs 5.000 job with 10% inflation to unemployment at 3% inflation!

To turn to the current inflation scenario in India, to my mind, the basic cause remains food price, which also influences non-food inflation through wages (directly through indexation or otherwise). (Global increase in commodity prices since the middle of 2009 is also a factor.) Higher food prices is a positive feature from a socio-economic perspective: it transfers purchasing power to the agricultural economy where the per capita income is less than half in the rest of the economy! The successive increases in the minimum support prices are surely aimed at increasing the prices the producer gets, to transfer income from India to Bharat. Again, many reports suggest that agricultural wages have gone up after the introduction of NREGA, the UPA's flagship program. But surely, this means higher agricultural cost and therefore prices? As T Nanda Kumar, former food and agriculture secretary, argued in a recent article in the Indian Express, "*If* *we force food prices to return to the levels of a few years ago, we will bankrupt our farmers*".

Overall, we need to accept the need for food inflation, perhaps for some years. The real failure is in the criminal waste of food through lack of storage facilities and infrastructure, the hurdles in introducing more productive seeds, etc. (Something like a third of vegetables rot, and currently 18 mn tonnes of grains purchased by the FCI are lying in the open!) Surely domestic and foreign investment in organised retail is needed to reduce the yawning difference between what the producer gets and what the consumer pays, to substantially increase the monetary and managerial resources needed for building infrastructure – not just breast-beating on food prices!

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