

Inflation, Growth and Monetary Policy

Tomorrow's policy announcement will be eagerly awaited by bankers and other market participants, thanks to the latest inflation number (8.43% in December). The Prime Minister's Economic Advisory Council has recently increased its forecasted inflation for March to 7%: even this does not seem to factor in the needed rise in diesel prices, even as crude oil nears the \$ 100/barrel mark.

The problem is whether monetary policy can do much to curb inflation given that the two major drivers are

- ⇒ Global commodity prices, which may keep rising with economic recovery in the developed countries, and fast growth in many emerging markets;
- ⇒ Food prices. It is unlikely people would eat less after yet another turn of the monetary policy screw. The problem is on the supply side, not demand side, and monetary policy cannot cure it. Incidentally, Mr. Gandhi believes that the price rise is because of the constraints of a coalition government!

Tighter monetary policy can of course reduce demand, and hence growth and employment generation, in the non-food sector. As it is, there are enough signs that the deflationary exchange rate, coupled with tightness in the money market, are slowing growth. Industrial growth has dropped to just 2.7% in November, an 18-month low. Many other indicators evidence the same phenomenon: the bearish sentiment in the stock market; the fact that corporate profitability in H1 showed no growth compared to a year back. (To be sure, "real" interest rates in India are the lowest in Asia, and the IMF continues to advise higher rates.)

Some economists look at the so-called “misery index”, only half in jest: it is the aggregate of the unemployment and inflation rates. The misery created by, say, 8% inflation and 5.5% unemployment is perhaps much less than 3% inflation and 10% unemployment -- though the index level is identical!

This apart, tightness in the money market is likely to persist as the forward margin on the dollar reduces the economic advantage of leading export receipts and lagging import payments in foreign exchange, shifting export and import financing from USD to INR.

Food prices

A couple of week back, the Government announced an eight point program to ease food prices: it includes sale of onions, cooking oil and *dal* by state agencies; and setting up of mobile markets for farm produce to eliminate middlemen. While one sees the political need to be “seen to be doing something”, one has doubts about the efficacy of the measures:

- ⇒ State agencies record in too many segments including in implementing various schemes from NREGA to CWG, is far from promising;
- ⇒ As far eliminating the middlemen to significantly narrow the gap between what the producer gets and what the consumer pays, encouraging organised retail, including with FDI, may be a far better way, particularly if the managerial and financial resources of the investor can be used to build rural infrastructure (roads, cold storages, etc), and reduce wastage. But we continue to drag our feet on this!

But this apart, sharply rising food prices does seem to be a global phenomenon. The FAO index has gone up 100% in 5 years. The FAO has also warned of a repetition of the 2008 crisis as prices keep rising. There have been riots in Tunisia, Algeria and other African countries. Arab countries like Libya, Jordan and Morocco have taken measures to control food prices. At least partly, the food shortages and hence price rises are the result of natural disasters, in Russia, Pakistan, Australia,

Brazil, Indonesia, all major producers of foodgrains. The U.S. has recently cut forecasts of the stocks of key products like corn and soybean sending prices soaring. And, in the European Union, which for a long time paid farmers for not producing (to keep prices high and stop stocks from rising), there are calls to protect Europeans from high food bills – even as Europe remains opposed to genetically modified food. (A parallel at home: our Environment Minister has banned the introduction of Bt-Brinjal)

Surely the ghost of Thomas Malthus (1766-1834) must be having a quiet laugh! He predicted that as agricultural output increases in an arithmetical progression, even as population grows geometrically, the world will face a major problem in feeding everybody. For a long time, output rises from larger land under cultivation, better seeds technology, farming methods, use of fertilisers and pesticides, the green revolution, etc, have managed to avoid that specter. Can it continue to be? In our case, the rise in food prices has a positive corollary as well – it transfers income from the non-agriculture sector to the agricultural sector, thus helping narrow the per capita income gap between the two.

Coming back to inflation control through monetary policy, now that he is no longer the Finance Minister, Mr. P. Chidambaram could afford to concede (Times of India, January 6) that *“I am not sure whether we understand all the factors that contribute to price rise nor am I sure whether we have at our hand all the tools to control inflation”*.

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