Controlling Inflation

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FORUM
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"Free Enterprise was born with man and shall survive as long as man survives".

-A.D. Shroff
1899-1965
Founder-President
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INTRODUCTION

Inflation has become a matter of great concern not only in developing countries like India but major developed countries as well. Its input has become more acute as a result of sharp escalation in food prices and never ending surge in oil prices in the last few months. While people with large discretionary incomes can absorb the escalation in monthly expenses in their stride, it is very harsh on the common man especially hundreds of millions living at the subsistence level.

There are various causes which lead to inflation which have been well documented in the past. The authors, Dr. S.R.K. Rao and Mr. S.S. Bhandare, have lucidly illustrated the various contributing factors in India. They have also pointed out the current inadequacies in computing the wholesale price index and the various consumer price indexes, both in terms of the base, the composition and the weightage given to various items. The last two factors particularly assume great significance in view of the marked change in the consumption pattern in recent years, both in urban and rural areas.

The authors, eminently qualified to dilate on the subject, have not only dealt with the causes but offered some very pragmatic solutions in terms of required changes in economic policies, the management of energy supplies, the critical need for improving infrastructure and most importantly adopting realistic management of monetary and fiscal policies.

One critical factor in the whole debate of this vital issue is the credibility of the index among the consumers and housewives.

Though the official figure of annual inflation, as revealed by the Government, based on the wholesale price index has been hovering between 3% to 4% currently and the Reserve Bank of India is projecting it to be between 4% to 5% for 2007-08, the live experience of most bulk consumers is very different, as consumer prices have been rising at a much faster rate in recent times. It is hence very necessary for the Government to evolve and adopt one common price index which has great contemporary relevance, as at present consumer price index and wholesale price index tell two different stories about inflation because of their composition.

However, what is more pertinent is that the Government must assure that sensible monetary and fiscal policies are adopted which act in tandem, improved delivery of public services and overall better governance. These alone can ensure price stability in the medium and long-term and make it possible to have a sustained GDP annual growth of 9% over the next two decades co-terminus with more equitable distribution of income.

The booklet is very readable and informative.

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CONTROLLING INFLATION

Dr. S.R.K. RAO*

Inflation indicates rate of rise in prices. It is a silent enemy that swallows the purchasing power of money incomes. All over developed economies, inflation is measured by Consumer Price Index (CPI). However, in India despite sixty years of independence such an index could not be constructed for the economy as a whole. Inflation continues to be measured by Wholesale Price Index (WPI), which is compiled in the Office of Economic Adviser, Ministry of Commerce and Industry, Government of India.

Wholesale Price Index (WPI) cannot be taken as a true measure of inflation; it is largely a Commodity Price Index. It does not capture prices paid for, besides others, health care, housing, public utilities, services of staff and servants, education, entertainment, etc. Further, contribution of unorganized sector (informal sector) to prices such as of retail trade, business, transportation etc., which is significant is not captured by Wholesale Price Index (WPI). That is how when a housewife goes for buying the necessities from the market, she faces the puzzle of prices not only not going down, but sometimes, going-up when Wholesale Price Index shows a decline in inflation.

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In India, besides WPI, we have four indices to measure consumer prices for four sections of the economy, viz., for Industrial Workers (CPI for Industrial Workers), for Urban Non-Manual Employees (CPI for Urban Non-Manual Employees), for Rural Labour (CPI for Rural Labour) and for Agricultural Labour (CPI for Agricultural Labour). These are mainly used for fixing wages and are published with a time-lag. Consumer prices in the rest of the economy are not reflected in these indices.

"Growth with stability" can become a reality only when, besides others, inflation is controlled. For this, fiscal, and monetary policies should act in tandem, without each pulling in different directions. Though Reserve Bank of India and Government of India fixed the inflation target at 4.0 – 4.5 per cent, in very recent times, even measured by WPI, inflation went beyond the danger limit of 6.0 per cent during the months of January 2007 to April 2007.

Shri P. Chidambaram, Finance Minister, underscored the following as the main causes for the recent rise in inflation: (a) hardening of commodities' prices particularly metals and crude oil, (b) supply-demand mismatch: First in sugar, then in wheat and pulses, (c)' increase in money supply due to large capital inflows, and (d) rise in public expenditure. No one can dispute with the diagnosis of the Finance Minister. The question is why the,Government did not "anticipate and act"? This is where the Government has failed, which I call "FOG – Failure of Governance" as the main cause of rise in inflation. Let us analyse FOG in each of the above causes of inflation:

(a) Hardening of Commodities' Prices:

With the globalisation of the economy, India cannot function in isolation. With foresight, the Government could have factored the "swings" in the international prices of highly speculative commodities like metals and oil and taken precautionary measures to provide "cushion" for their price rise. In private sector some of the big companies have their agencies/agents at strategic places abroad to keep their "ears to the ground" and inform their Headquarters as to when and by how much these commodity prices are likely to rise. Has the Government such agencies/agents posted abroad to inform it in advance the likely rise in prices of metals and oil and other important commodities? To say "We are caught by surprise" is admission of FOG: Failure of Governance.

(b) Supply – Demand Mismatch:

Union Ministry of Agriculture in coordination with other Ministries1 departments could have made projections of likely demand for items like sugar, wheat, pulses etc., and taken proper precautionary measures by augmenting their stocks to meet with the likely demand. The attitude of "let us come to the bridge, then we think of how to cross it" by the Agriculture Ministry is largely responsible for the price rise in these articles. Mere import of huge quantities of these articles is no panacea to arrest their price rise; they should reach the ultimate consumer at the right time and at the right price. Faulty public distribution system, corruption in "fair price shops" (ration shops), wastage, pilferage etc., are some other factors which added to inflationary pressures in the economy.

(c) Income in Money Supply due to large capital inflows:

Foreign Exchange Reserves (forex reserves) which were mere US 1.9 billion dollars in 1991 have risen to more than US 200 billion dollars in 2007 (June). They comprise, among others, Foreign Direct Investments (FDIs), Foreign Institutional Investments (FIIs), short-term credits, banking capital, invisible receipts, workers remittance (NRIs remittances), and revaluation of currencies kept in reserves. It may be noted that while forex reserves rose, India's external debt also rose from US 131 billion dollars in 2006 (June) to US 142 billion dollars in 2007 (April). When capital inflows take place, an equivalent amount of rupees have to be released by the central bank of the country. If the inflows are on large scale, equivalent rupees released would add liquidity to the market, which will accelerate inflationary pressures. If the capital inflows are drastically curtailed or slowed down. Since our current account deficit is already high at US 10.6 billion dollars, it would adversely affect the balance of payments position. This is what I call "Dilemma of Capital Inflows (DCI)". To ward off the inflationary effects of huge capital inflows, a substantial portion of them can be sanitizedl and/or Sterilised. Sanitation can be done by investing these funds in long-term projects (infrastructure sector). Sterilization can be done by absorbing a substantial proportion of these funds by investing them in special long-term bonds with a low rate of interest or no interest for periods ranging from 15 to 20 years. The problem. however, is there is no reliable data as to how much of these are "hot money" which may be withdrawn at short notice. Neither the Government, SEBI or RBI monitor such data. Though RBI operates Market Stabilization Scheme to absorb capital inflows,

the "CAP" on it blunts its effectiveness. According to one estimate, nearly 75% of total capital inflows are "hot money" ("Hindustan Times", April 12, 2007). Another example of FOG!. Though a large volume of forex reserves should be welcomed, its non-utilization for productive purposes is a matter of concern. It is resulting in high carrying costs. While the large sums of non-utilised forex reserve are invested abroad, especially in US Treasury Bills and Bonds at a low rate of return, cost of acquiring them at a higher rate is resulting in huge loss to the Indian exchequer.

It is for consideration (a) how to solve the "Dilemma of Capital Inflows" (DCI), and (b) how to reduce to the minimum the forex carrying costs. Time and again, RBI insists that its monetary policy's objective is "Growth with stability". It is evident that while "Growth" is "happening" not due to monetary policy only, "stability" is eluding in many sectors of the economy. High interest rates, rising rupee, squeeze of liquidity etc., may serve as "shock treatments", but if pursued long, they may become counter-productive. Asked what should be the ideal monetary policy, Mervyn King, Governor of Bank of England said: "NICE – non-inflationary consistent expansion of money supply". It is said that at present rupee is almost fully convertible on Capital Account. Road Maps are laid down by Expert Committees to make rupee fully convertible on Capital Account very soon. If the Government and the monetary authority (i.e. RBI) are to play an effective role when Rupee becomes fully convertible on Capital Account, "institutional inadequacies" in the economy should be set right. When large volumes of capital inflows add

huge liquidity to the market resulting in higher inflation, growth and stability would be adversely affected.

(d) Rise in Public Expenditure:

There is nothing new in the Finance Minister mentioning rise in public expenditure as one of the causes for higher inflation; it is an old song set to a new tune! Much of this is for interest payment, subsidies, pension and salaries, etc. According to one estimate, the growth in public expenditure (i.e. public debt and other liabilities) during the next fiscal would be about Rs.2,07,979 crore, or, Rs.575 crore per day, (S. Gangadharan, DNA, March 13, 2007). In 2006-07, Debt-GDP ratio was as high as 62 per cent. Government's liabilities comprise public debt – both internal and external – special securities, overseas borrowings and other liabilities such as Small Savings. One can only imagine what would be the impact of the recommendations of Sixth Pay Commission regarding the revision of salaries and perquisites of Government employees on Government finances and their cascading effects down the line in states and other quasi-Government organisations!

With a view to regulating fiscal and revenue deficits in Government's budget, Fiscal Responsibility and Budget Management Bill was passed into an Act. (FRBM Act 2003). Under this Act, Government should bring down fiscal deficit to 3 per cent of GDP by March 2009 and completely eliminate revenue deficit by 2008-09. The question is how far the fiscal deficit figures shown in the budget are transparent? According to Dr. C. Rangarajan, former Governor of Reserve Bank of India, fiscal deficit figures shown in the budget are underestimated;

many items are not included in the "Government liabilities". For example, he points out, Oil Bonds, which have now become a regular feature, amounting to Rs.28,000 crore this year, are not included as "Debt". If this is included, it would have added 0.7 percentage points to GDP ratio. (Economic Times, February 19, 2007).

Is the Government losing confidence in its capacity to adhere to the targets set in the FRBM Act? Already economists in the Planning Commission - especially its Deputy Chairman – questioned the logic behind the setting up of targets for fiscal and revenue deficits in the FRBM Act. It is contended by them that it is not fiscal contraction, but fiscal expansion that is growth enhancing. Their argument has to be taken seriously because rightly, or wrongly, it is assumed "what Prime Minister thinks today, Planning Commission echoes tomorrow"! If the resources generated by fiscal expansion are invested in productive activities, without long gestation-lags, the argument appears to be convincing. However, if they are diverted to non-plan, non-development usages, it would contribute to higher inflation. There is no guarantee that the additional resources generated by "side-stepping" the provisions of FRBM Act 2003 would be invested in productive activities. We have seen that on every front failure of governance (FOG) has caused escalation in inflation in the economy, As such the present position of revenue deficit, according to the Finance Minister, is expected to be 1.5 per cent of GDP at the end of the fiscal year 2007-08, a reduction of 50 basis points compared with last year fiscal 2006-07. If FRBM Act's target of revenue deficit has to be achieved, viz.,

zero per cent of GDP by 31st March, 2009, Government should reduce its revenue deficit by a further 150 basis points. Under these circumstances, some economists are of the opinion that any deviation in Government's fiscal policy might adversely affect India's sovereign rating. (MINT 29th May, 2007). Therefore, targets fixed for Fiscal and Revenue deficits in FRBM Act, 2003 should remain binding on the Government.

Concluding observations and policy suggestions

The recent rise in inflation in the Indian economy cannot be attributed to any internal (e.g. severe drought, earthquakes, floods etc.) and/or external factors (e.g. wars, international currency crisis etc.). With efficient governance and deft handling of the problems, inflation could have been controlled. Simplistic explanations such as "price rise was due to demand exceeding supply", "too much money chasing too few goods" etc., sound "text bookish" and escapist at their worst! The Government failed to anticipate and act by taking proper measures to arrest rise in prices, especially of essential commodities.

Further, inspite of repeated warnings by eminent economists and jurists that its huge public expenditure on non-development activities was compelling it to borrow from open market on a large scale, the Government appears to have done precious little to curtail its profligacy. When large capital inflows were taking place, the Government did not have any machinery to monitor how much of these inflows were "hot money" and what part of the inflows could be "sanitized"/and/or "sterilized" to prevent excess liquidity that would push up inflationary

pressures. Inflation witnessed today in the economy is largely due to "FOG – Failure of Governance".

Let me conclude with the following suggestions to deal with the challenges of rising inflation:

First, inflation should not be tackled on "ad hoc" basis. While oil exploration should be deepened and widened, and alternate sources of energy should be found, oil consumption by the general public must be minimized. Curtailing, if not abolishing subsidies to POL may be one of the means to curb their rising public consumption.

Second, agriculture has been neglected far too long in terms of public and private investment. Planned crop cultivation is necessary to minimize the mismatch between demand and supply of essential agricultural commodities. Here planning for short, medium and long-term development of agriculture on scientific basis is very essential not only to raise production but also productivity.

Third, it is unfortunate that agriculture, instead of being a way of life for farmers has in recent years become for many a way to end life! The following suggestion may be considered by the Government to alleviate the misery of the farmers to benefit marginal and small farmers. Agricultural Debt Redemption Corporation (ADRC) may be set up which would buy loans taken by a farmer up to rupees three lakhs from a bank and/or a cooperative bank against a long-term bond of 10-15 years maturity issued by it. These bonds, negotiable and tradable,

could be used by the receiving bank/cooperative bank for purposes of SLR and liquidity requirements mandatory under law. The debtor farmer and his guarantor will thus be discharged from his debt. However, he and his guarantor through a separate agreement would over a period of 10-15 years repay ADRC in kind, viz., a part of his produce valued at the market price ruling at that time or in cash by instalments. Loans from moneylenders may be repaid giving them securities of State Governments under whose jurisdiction they operate.

Fourth, Government should strengthen public distribution system of essential food grains, besides other necessities and involve state Governments in maintaining price stability.

Fifth, Government should be vigilant about the quantity as well as the quality of capital inflows. It is time an efficient machinery is set-up to monitor how much of these capital inflows are "hot money" and detect whether laundered and speculative money is entering the money and capital markets under different "labels".

Last, monetary policy alone cannot curb inflationary pressures. Fiscal policy should work in tandem with it. Government should curtail its profligacy in spending on non-productive activities. Political considerations should give place to pragmatism. Targets fixed in FRBM Act, 2003 should be binding on the Government and they are not to be "side-stepped". If the governance is committed and efficient, inflation can be controlled by the Government.

STRATEGIZING THE BATTLE AGAINST INFLATION

HOW FAR ARE WE?

S.S. BHANDARE*

By the time this article finds it way into the pages of MEDC's Monthly News Digest, the Reserve Bank of India (RBI) would have released its quarterly review of monetary and economic developments. In all certainty, the RBI would reflect on the rapidly moderated inflation rate over the last three months with a mood of self-congratulation – and legitimately so. The inflation rate, measured in terms of Wholesale Price Index (WPI), which was surging in the danger zone of 6.7% in early February 2007, has more or less consistently dropped to around 4.3% for the week ended June 30, 2007 on a year-on-year basis, (Indeed, the inflation rate had earlier dropped to 4.1% in the middle of June 2007 – the lowest rate over the previous ten months).

This is no mean achievement in the midst of several adverse conditions. Perhaps, the RBI itself may not have anticipated such a positive outcome of its own policy initiatives as well those of the Ministry of Finance (MOF). Both the RBI and the MOF surely deserve congratulations for steering the path of

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moderating inflation. However, one envisages the RBI to retain its cautious monetary policy stance thanks to some reversal in the falling inflationary trends in the last couple of weeks, and the renewed surge in the international crude oil prices.

Also, there are issues about reconciling the proclaimed "official reality" of the falling inflation rate, and the "popular perception" about the continued high inflation rate. The common man in general, and the articulate middle-class consumer households in particular, continue to be dissatisfied and believe that inflation is still high, and hurting them the most. Consequently, there are some critical issues calling for more detailed analysis and careful evaluation:

* First, why is there such a divergence in the official measurement of inflation and the popular actual experience of inflation?
* Second, how sustainable is the current moderation of the inflation rate? What are the straws in the wind?
* Last, what are the implications of softening of the inflation rate on the likely behaviour of key macro policy parameters, namely, the interest rates (which have risen sharply over the last year) and the exchange rate of the rupee (which has appreciated rapidly over the last six months)?

A Word about **Globalizing** Inflation Rate:

Undoubtedly, India has moved quiet decisively from the frequently prevalent phenomenon of high inflation often going beyond 7% - and there were at least 13 or 14 years of double

digit inflation during the span of over 56 years of economic planning – to a relatively moderate inflation rate in the recent years. Witness the average annual inflation rate (based on WPI) in the post-reforms period: 10.6% during 1991-96; 5.1% during 1996-2001; and further to 4.9% during 2001-07.

Evidently, domestic deregulation; import liberalization through virtual abolition of import licensing; and across-the-board rationalization and reductions of commodities taxation (customs, CENVAT and State VAT tariffs) have all contributed towards intensifying competition, promoting cost-efficiency, improving supply management, and restraining upward pressures on prices. In the manufacturing sector, where there has been a more radical transformation, the deceleration of inflation has been more pronounced since the mid-nineties, as can be observed from the following table I:

Table I: The Average Annual Inflation Rate (Based on WPI)

Period	All Commo-dities	Primary Articles	Fuel, Power Light & Lubricants	Manufactured Products
1991-1996	10.6	11.3	11.3	10.1
1996-2001	5.1	5.4	13.0	3.1
2001-2007	4.9	4.5	7.4	4.3

Note: The up-scaling of inflation in the latter part of 2006-07 has raised the overall long-term average inflation rate for the period 2001-07.
WPI = Wholesale Price Index

Increasing globalization of the Indian economy requires our benchmark inflation rate to be aligned with the global standard – which is as low as 2 to 2.5% in the case of most of our major trading partners and global investors. Thus, while our recent long-term inflation trend appears to be promising, it still remains very high in the context of the current global standards/norms.

The monetary policy generally sets the average annual inflation target in the range of 5 to 5.5 percent. Indeed, in recent times both the PM and the FM have been talking about much lower inflation target of 4 to 4.5%. More recently, the PM's Economic Advisory Council has pegged the inflation target "within 4%" for 2007-08. Obviously, the tolerance limit of inflation (or Indian consumers' and policy makers' aversion to inflation) is coming down sharply, and in the coming years, the inflation rate will have to converge with the global standard. But the crucial issue is certainly not about its desirability, but how to make it achievable on a sustained basis.

The Warning Signals of 2006-07:

The falling trend of inflation rate in India has been broken in the latter Half of 2006-07. Indeed, the year-on-year inflation rate (based on the monthly averages of WPI: 1993-94 = 100) peaked in March 2007, before declining since then. (Please see Table II)

The most striking part of the recent inflationary trend is that the Fuel Group, which has a fairly high weightage of 14.23% in the WPI, has shown a contrarian pattern – dropping progressively and sharply to the negative rate of ***0.8*** percent in May 2006. This conceals more than what it reveals. It is not that we are managing our fuel supply and pricing policy competitively or

efficiently. It is just a reflection that on grounds of political expediency, the Government is virtually continuing the administered price controls on the one hand, and granting fiscal reliefs involving reduction of customs tariffs and excise duties applicable to crude oil and petroleum products on the other.

In a sense, the Government has sought to "repress" inflation by refusing to adjust the prices of petroleum products upwards in response to the international rising prices of these products and in the process making the oil companies suffer the massive erosion in their profits. This strategy is also causing wasteful usage of certain categories of fuel ,especially kerosene and LPG.

Table II: The Recent Inflationary Trends

Year-on-year	All Commodities	Primary Articles	Fuel Group	Manufactured Products
July 2006 (the low)	4.8	5.0	7.4	3.7
Dec. 2006	5.7	9.0	3.7	5.2
March 2007 (the high)	6.6	11.8	1.4	6.8
April 2007	6.3	11.9	1.1	6.2
May 2007	5.2	9.9	0.6	5.1
June 2007	4.3	7.4	(-) 0.8	5.2

Recognizing the multiple adverse impact of inflation – that it hurts the poor most; that it puts pressures on interest rates and exchange rates; that it affects both savings and investments – both the Government and RBI introduced series of anti-

inflationary measures during 2006-07. The key strategy has been to manage both supply and demand sides of the inflationary equation.

Thus, on the supply side, the Government increased import of wheat during 2006-07 (5.5 mn. tonnes); permitted import of pulses at zero duty and imposed ban on their exports; reduced duty on palm oils; effected cuts in duty on portland cement, various metals and machinery items;, reduced excise duty on low priced cement, etc. Further, the Government reduced prices of petrol and diesel by Rs.2 per litre and Re.1 per litre, respectively with effect from February 2007. To compensate for the losses of the oil companies due these price reductions, the MOF cut the ad valorem component of excise duty on petrol and diesel from 8% to 6% in the last budget. Indeed, the customs and excise rationalization process has become an integral part of the continuing "soft" strategy of the Government to mitigate the adverse impact of surging international crude oil prices since mid-2004.

Besides, the appreciation of the rupee by over 10 percent in the last about six months has reduced the cost of imports in general, and of essential commodities in particular. Indeed, the rising external value of the rupee has been a blessing in disguise for the Government fighting its inflationary battle.

On the demand side, the RBI has progressively raised the interest rates and sought to control the growth of liquidity in banking system through hikes in the Cash Reserve Ratio (CRR). Thus, the repo rate has been hiked to all time high of 7.75%, and CRR has been raised progressively to 6.5% by

May 2007. The tightening of liquidity has escalated further the lending rates of banks by 50 to 100 basis points; the PLR of banks, for example, having gone up to the range of 12.75 to 13.50% in early months of 2007.

These policy measure have yielded some positive results, as is evident from both the table II as well as table III (as set out below), which shows how various measures of inflation – whether WPI or CPI – have dropped in recent months from the high points reached either in February or March 2007.

Table **III:** The Inflation Divergence – WPI and CPI

Year/Month	WPI	CPI (IW)	CPI (AL)	CPI (Middle-class)
2004-05	6.4	3.7	2.4	3.8
2005-06	4.4	4.0	4.7	4.5
2006-07	5.4	6.8	7.6	6.6
February 2007*	6.3	7.6	9.8	7.8
March 2007	6.6	6.7	9.5	7.6
April 2007	6.3	6.7	9.4	7.7
May 2007	5.2	6.6	8.2	6.8
June 2007	4.3	n.a.	n.a.	n.a.

*Notes: (1) Inflation divergence between the WPI and various measures of CPI is largely due to the divergence in weighing diagram of these indices and methods of their respective construction.(2) n.a. represents not available. Consumer Price Index (CPI) data has a longer time lag, and is available on a monthly basis. Hence, the WPI, which is worked out on a weekly basis, is more commonly used for measuring inflation. (3) IW = Industrial Workers; AL = Agricultural Labour; * The recent high inflation level of all the Consumer Price Indices*

Yet, the most worrisome feature is the extent of divergence between WPI and CPI. Indeed, just about three months ago, there prevailed a very threatening situation of a double digit inflation rate in the cost of living of agricultural labour, and closer to the 8% level in the case of industrial workers and the urban middle-class.

In the popular understanding of the inflationary phenomenon, it is the CPI that is more close to the reality than the WPI, as it is more comprehensive than the WPI in terms of coverage of goods and services relevant to the given section of the community – be they industrial workers, agricultural labourers or the typical urban middle-class households. The weighing diagram in terms of importance of goods and services that enter the consumption basket makes significant difference in the realistic measurement of inflation. The substantive issue is that even the current moderating levels of inflation are high and hurting severely the interests of the consumers.

In this context, the concepts like "core inflation" or "headline inflatibn", which are increasingly in vogue in the current economic analysis and official policy making, while serving as relevant parameters, are of no consequence from the viewpoint of common man or ordinary consumer. For him what matters is the inflation in the retail market place or at a typical grocer's shop.

Incidentally, there is a logical build up of prices at the retail end (over the wholesale prices at the village mandi and/or

APMC market centers in the case of agricultural products or at the factory gate in the case of manufactured goods). This comprises of not only the cumulative burden of all indirect taxes (including octroi and entry taxes, wherever applicable) and transport and distribution costs, but also the costs of all the inefficiencies of supply chain and transactions management. Not surprisingly, the huge spread between the wholesale and retail prices is not captured in the official proclamation of inflation rates, measured in terms of WPI alone.

What is necessary, therefore, is to construct a more broad-based national Producers Prices Index (covering commodities and services) and a set of other indices capturing key sectoral (Housing, Services, Construction, Infrastructure, etc) and consumer price indices for selected household income/consumption categories. In this context, it is interesting to observe that the last three or four Economic Surveys, published by the Government of India, have almost repeatedly mentioned about the various initiatives and the reports of Expert Groups appointed by the Government for this purpose, but unfortunately, the actual formulation and release of such credible and comprehensive data series on prices so far remains to be implemented.

What is also necessary is to harmonize and bring various indices for the measurement of inflation to the common base year, which should in no case be earlier than 2000-01. In fact, the time is opportune to select 2005-06 as the new base year for all price

and production indices. Otherwise, the data will tend to become increasingly obsolete thanks to their age old base years.

Sustainability of Softening Inflation

Having said this, the official proclamation of softening inflation, based on the WPI, is a laudable achievement. But the major issue is about its sustainability on a long-term basis. There are at least five major factors that are likely to vitiate the inflation management in the ensuing months.

* First, at the macro level, there is a proverbial inflationary gap manifesting between growth rates of real GDP and money supply (M3). Although in the post reforms period this relationship has become somewhat tenuous, it can not be just wished away. The fact of the matter is that excessive money supply growth in relation to real GDP growth generates (or even accentuates) with a time-lag inflationary pressures in the economy.

  Evidently, there is a large liquidity overhang arising out of rapid money supply growth in relation to real GDP growth of the last two years. (Please see Table IV). And the current indicators clearly suggest that this phenomenon is likely to continue thanks mainly to rapid growth of both foreign exchange assets and commercial credit. Banks are currently experiencing flush of deposit growth, which stimulates them to explore the avenues of credit deployment, albeit demand for credit is currently showing distinct signs of deceleration. As a consequence, banks may be forced to reduce the lending rates in the bargain.

Table IV: Real GDP-Money Supply- Inflation Relationship

Growth Rates (%)	Real GDP	Money Supply (M3)	WPI	CPI
2003-04	8.5	16.7	5.5	3.9
2004-05	7.5	12.3	6.4	3.7
2005-06	9.0	17.0	4.4	4.0
2006-07	9.4	20.8	5.4	6.8
2007-08 (P)	8.5 -9.0	17.5–18.0	5–5.5	6.5–7.0

Notes: (1) Inflation rates worked out on the average annual WPI and CPI. (2) (P) represents our projections for the year.

* Second, the international crude oil prices, after experiencing a lull for a brief period, have started surging again in the last few weeks. The Indian crude oil basket touched an all-time high of $73.96 a barrel in the middle of July 2007 as compared to $65.52 in April 2007 and just about $62.46 a barrel for the financial year 2006-07. The International Energy Agency in its recent report has unveiled medium-term risk facing the global energy market. It has raised the forecast for global oil demand (from 2% per year to 2.2% over the next five years), which has triggered a strong rally in oil prices. Even the generally conservative Economic Intelligence Unit (London) has now scaled up its forecast of crude oil prices to $70 per barrel for 2007 and 2008 from its earlier forecast in the range of $55-60 per barrel. Given India's huge import dependency on crude oil, the emerging oil price scenario has unleashed new uncertainty in the management of inflation in the country.

According to the spokesman of Indian Oil Corporation (based on the previous data), with every dollar a barrel rise in crude oil prices, there is a need to raise retail prices of petrol by 39 paise a litre, diesel by 30 paise, kerosene by 36 paise and cooking gas by 67 paise. Further, every $1 increase in crude price has monthly impact of Rs 100-Rs 120 crores on the four products. If there is no *pari passu* upward revision of petroleum refinery products, the company at present suffers a loss (due to under realization) of Rs 143 on sale of 14.2 kg domestic cooking gas cylinder, Rs 18 per litre on kerosene, Rs *7.75* a litre on diesel, and Rs 5.50 a litre on petrol.

* Third, there are growing capacity constraints in a host of basic industries like cement, steel, capital goods, etc. creating strong impetus for the players in these industries to raise prices often ahead of cost escalations experienced by them.

* Fourth, there are pressures building up practically in every single area of infrastructure facilities. Apart from hurting the efficient production and distribution of goods and services, such a phenomenon will cause escalation of cost burden for the economy.

* Last, capacity building with respect to manpower is a newly emerging challenge for the economy, which is rapidly going to dilute India's wage cost advantage. This phenomenon, which is noticeable in certain services sector and the organized manufacturing sector, will in coming years spread to the rest of the economy, including in agricultural operations. In the absence of comprehensive efforts to expand the skill

base of the economy and improve productivity of manpower, the challenge of "wage push" inflation can not be resolved.

On the positive side, however, there are three significant factors: First, the encouraging indications of the progress of monsoon, and increases in area under some of the kharif crops, especially the commercial crops. For example, acreage under oilseeds is reported have increased by about 9%; and cotton acreage is up by about 19%, as compared to the previous year. Second, the easing of demand for bank credit, especially non-food credit and the consequent expectations of softening of interest rates – banks are now flushed with liquidity with deposits growth accelerating at the same time. Last, the gains of appreciating rupee in terms of reduced cost of imports across-the-board.

Implications for Interest & Exchange Rates

Undoubtedly, there is always a very robust inflation-interest rates-exchange rates nexus. The widening inflation differential with major trading countries with some given time lag often leads to weakening of the currency of the concerned economy. This is an inevitable impact of the erosion in the competitive strength of the economy caused by high inflation. In turn, it propels the interest rates to rise, accompanied by monetary tightening to prevent further deterioration of the external value of the currency.

The current Indian situation is distinctively different. There still prevails a large inflation differential between India and her major trading partners and competitors in the global market. Yet the rupee in the last four months has emerged stronger by the day. This is an outcome of remarkable vote of confidence in the future of Indian economy in the perception of foreign

investors, including our own NRIs. In turn, there are unrelenting massive capital inflows, causing basic imbalance in terms of excess supply of foreign exchange resources (including dollars) in relation to their demand, thereby leading to the on-going appreciation of the rupee.

From the viewpoint of managing inflation through cheaper imports this is a favourable situation. Illustratively, it mitigates to a great extent the need for very sharp immediate hikes in the petroleum product prices as well as of essential commodities like wheat and edible oils, whose prices in the international markets have risen substantially over the year.

With continuing uncertainties on the inflation front, there is unlikely to be easing of pressures on interest rates in the official credit policy of the RBI, although the current slackening of demand for non-food credit will prompt banks to reduce interest rates on their new lending. However, as most experts have convincingly sought to argue, there is an urgent need to calibrate the exchange rate movement and prevent further appreciation of the rupee. Indeed, the RBI needs to signal its stance in favour of some reasonable correction in the exchange rate. Building up a competitive economy at the current external valuation of the rupee can not be achieved in a swift manner – it can only be a long-term strategy, whose success will depend upon various new set of policy initiatives.

In Summing Up

It is clear that Indian inflation on a longer-term basis is softening thanks to the growing intensity of internal competition and increasing globalization of the economy. However, the

uncertainty on the inflation front will continue to loom large. Several negatives are going to shape both the short-term and long-term inflation outlook of the Indian economy – the basic domestic supply side and infrastructure constraints; uncertainties of global oil prices; strong emerging pressures on the wage costs, especially of the skilled workers, including technology and knowledge manpower; and so on.

At the same time, the demand side will be driven by rapid growth of money supply largely under the impetus of foreign exchange reserves; growing consumption demand propelled by high income growth; and investment demand.

Besides, there are new "high growth aspirations" (not less than 9% annual real GDP growth); and there are new "lower limits of inflation aversion" (not more than 4% annual inflation rate). The combination of two offers tough, but fascinating challenges. One would like both these goals to be mutually manageable and bereft of any trade-offs. But is it going to be so?

In this frame-work, strategizing the battle against inflation is a task that can not be left to the RBI's monetary policy alone? Nor can one expect the *ad hoc* fiscal (customs and excise reliefs) and supply management measures (import of wheat and edible oils) to be effective on an enduring basis. What can truly make the difference to this outlook on a sustained basis are the strategies to bring about

* First, the next agricultural revolution;
* Second, the management of energy security;
* Third, expansion and modernization of critical infrastructure;

* Fourth, the capacity building of manpower; and
* Last, the good fiscal governance.

In short, the battle against inflation is far from over. ...And thereby unfolds the story of the Government's and RBI's unrelenting vigilance and struggle for balancing stance of ***"managing growth with consolidation of moderate inflation7***

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

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The Forum of Free Enterprise is a non-political and non-partisan organisation – started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life, The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets, meetings, and other means as befit a democratic society.

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