THE CURRENT PRICE SITUATION

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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
Forum of Free Enterprise

THE CURRENT PRICE SITUATION

I

Resurgence of Inflation

By

S.S. Bhandare*

What is ailing the Indian economy? Confusion, contradictions and contrasting trends! All these and more. The political drama of pressures and counter-pressures on the present coalition government continues unabated, thereby compounding the problems of the present economic situation. And what about the rising prices? **The return of high inflation.** No doubt, it is yet to transgress the danger limit of double-digit inflation. Also, there is so far no unleashing of inflationary psychosis either. While there seems to be manipulation of supply situation by traders and speculators in a few commodities of mass consumption, consumer behaviour is perceived to be far more restrained; there is no chasing of too few goods, particularly the primary articles. In fact, many consumer and industrial goods are battling with the problems of plenty in the midst of sluggish demand.

Even so, we cannot be complacent about the phenomenon of persistently rising prices for the past many weeks. The **inflation rate,** measured in terms of

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Wholesale Price Index (WPI), **touched the peak of 8.32%** for the week-ended July 25, 1998 on year-on-year basis (y-o-y). And after declining to 7.94% the week ended August 8 it shot up once again to 8.78% by August 29, 1998. This rate marks the 148 week high – highest level since mid-November 1995, when the inflation rate was 8.6 percent. In fact, the price based on the **Consumer Price Index (CPI)** for industrial workers has crossed the double-digit level (12.4%) over the year ended June 1998. There is clearly in evidence a resurgence of inflation, which is worrisome in the context of our own recent trends, and also in comparison with the global situation.

It may be recalled that during the crisis of 1991, the country suffered a trauma of rapidly escalating inflation with the WPI scaling the peak of 17% by August 1991 on y-o-y basis. Thereafter, thanks to reforms with its immediate thrust on macro-economic stabilisation on the one hand, and facilitated by favourable supply management of mass consumer goods on the other, the price situation was gradually brought under control. **The inflation rate reached 3.4% on y-o-y basis by September 27, 1997** – the lowest in our recent economic history. The fact that India could also secure an average real GDP growth of 7.5% during the three year span of 1994-97 accompanied by such falling inflation, made our achievement remarkable by any standards.

However, **our good fortune of high growth with moderate inflation has proved to be short-lived.** At present, the economy is not only witnessing a slowdown in its growth performance, especially of the industrial sector, but also the return of rising prices. In short, the Indian economy is beseiged with rising inflation in the midst of industrial slowdown or sectoral recession.

As is to be expected, the government has sought to argue that the present upsurge in prices is a short-term and seasonal phenomenon. Indeed, the Prime Minister, in his Independence Day address has attributed the spiralling prices of essential commodities to hoarding and profiteering and has sought to reassure the people that the Finance Ministry and the State Governments will work together to combat the rising prices. In this context, we seek to evaluate **some critical questions about the current price situation:**

- What are the causes of inflationary resurgence? Is this a temporary or a seasonal phenomenon?
- What are the implications of rising prices?
- What policy measures are required to deal with the prevailing situation?

The Statistical Overview:

Before turning to some of these critical issues, **it is appropriate to analyse the relevant data** with a view to assessing the nature of cause and effect relationship.

- First, the inflationary upsurge is mostly confined to primary articles and `fuel, power, light & lubricants' groups, wherein price increases over the year ended July 25, 1998 were of the order of 13.6% and 8.7%, respectively.
- Second, the unprecedented price rise in primary commodities is mainly a reflection of the `supply

shock'. This is evident from the soaring prices of many vegetables, fruits, spices and condiments, tea, fish, oilseeds, edible oils, etc. However, there is no perceptible price rise in foodgrains.

- Third, according to the CMIE Study, out of 447 commodities, the WPI of 28 commodities increased by more than 20% during June 1998 as compared to the level a year ago. *"These commodities with a cumulative weight of 8.82 percent contributed nearly two-third in the overall increase in the WPI".*

Selected Commodities Scoring Over 20% Price Rise (June '98 over June '97)

Potatoes	378.6	Papaya	30.3
Onions	82.4	Rectified Spirit	28.6
Oranges	72.8	Powerloom Cloth	26.8
Black Pepper	49.7	Groundnut Oil	26.8
Cardamom	36.1	Timber Planks	25.4
Turmeric	34.8	Chillies	23.9
Cotton Seed	33.7	Ceramic Tiles	23.2
Linseed Oil	32.4	Kardi Oil	21.0
Packed Tea	30.4	Tea	20.6

- Last, the `**manufactured products' group** is for the third year in succession, displaying an overall **subdued inflation rate of over 5% for the year ended July 25, 1998.** Obviously, this is a **reflection of severity of competition** on the one hand, and market compulsions to absorb cost-push pressures thanks to the lack of demand buoyancy for many industrial products on the other.

Continuously rising prices have not only adverse socio-economic impact, but political implications. This phenomenon jeopardises the survival prospects of the government in power. It provides a powerful leverage for launching the anti-government campaign for the opposition. Even the coalition partners of the present government are becoming increasingly restive, and in fact some of them are repeatedly pleading for more effective measures to deal with rising prices.

The Cause & Effect Relationship:

In the analysis of the present price situation, we would refrain from going into rigorous theoretical/analytical framework of cause and effect relationship. Suffice it to say, economic literature in this sphere is replete with intense and acrimonious debate between `monetarist' and `structuralist' schools of thought. The debate is unlikely to be any different even at present. Undoubtedly, the casual relationship among key macro-economic variables impacting the inflation behaviour is complex, and is at best left to theoretical experts.

We believe that quite apart from the secular long-term forces such as growth of population, real income growth, distortions in the patterns of income distribution, structural imbalances, etc, **there are some specific factors impacting the current price situation.**

First, the main reason for the supply side setback is a **decline of 3.7% in agricultural production** during 1997-98. In particular, foodgrains production dropped from about 199 mm tonnes in 1996-97 to 194 mm tonnes in 1997-98 or by about 2.6%. Although, there was an immediate spurt in prices of cereals and pulses, in the last few months the price rise in these commodities has been reversed.

But such a favourable situation is not being observed in the case of other primary commodities, particularly fruits and vegetables and edible oils, wherein the price increases have been phenomenal. According to official reports, the fall in production of potatoes, onions, and oil seeds in 1997-98 was as much as 24%, 15% and 7.6% respectively. Surely **traders and speculators have been exploiting such supply shortages** and aggravating price increases in these commodities. Not that the farmers are likely to be the real beneficiaries because typically the large spread between farm prices and retail prices is generally usurped by the intermediaries to the detriment of both farmers and consumers.

In respect of foodgrains, however, what is worrisome is that despite ten consecutive "normal monsoons", the long-term trend growh of foodgrains outpout works out to about 2.5% per annum. This is just slightly higher than the annual growth rate of population. If the long-term economic stability is to be the major desideratum of agricultural policy, then **there is an urgency of stepping up growth in foodgrains production.**

In substance, the principal source of the current inflationary upsurge is soaring prices of primary commodities, most of which suffered a major setback in production due to the erratic monsoon of the previous year. To some extent, the price rise is also seasonal in nature. Therefore, there is a prospect of a post-harvest seasonal dip in prices with the arrival of new crops from October 1998. Even so, we believe that **the overall inflation scenario remains uncertain.** It is important to reckon that over the years, the seasonal downtrend in prices of agricultural commodities is becoming weak, thanks to the general improvement in the stock holding capacity of producers. By and large, therefore, the **inflation rate can be expected to remain sticky at the current high level.**

Second, there is a persistent build-up of inflationary gap due to **high money supply (M3) growth** of 17.6% in 1997-98 in the wake of reduced growth of 5.1% in the real GDP. Even in the current financial year so far (April-July 1998), M3 growth is forging at the rate of well over 17% on y-o-y basis. Simultaneously, there are **no strong favourable indicators of a major recovery in real GDP growth.**

Third, not only is the quantum of M3 growth in relation to real GDP causing the widening of inflationary gap, but even **the quality of M3 growth leaves much to be desired.** Thus, the major spurt in M3 growth has come from a **persistent high fiscal deficit.** It may be recalled that the progress of economic reforms is inextricably lined with fiscal consolidation. But after the initial success in this sphere, there are now consistent slippages in the fiscal discipline. Thus, in 1997-98, fiscal deficit to GDP ratio (FDR) reached 6.1% as against the target of 4.5%. The current trends clearly indicate that of the incremental increases of Rs.33,653 crores in M3 during the current financial year so far (April-mid July), the contribution to net bank credit to the government sector was far in excess at Rs.36,566 crores.

What, therefore, needs to be emphasised is that in the **management of price situation** the quality of fiscal deficit assumes considerable relevance, and in particular, **the failure of the government to roll back the large revenue deficit is becoming a major villian of the piece.** Not only is the economy being deprived of the sizeable investible resources for capital formation and subsequent stream of income generation, but persistent large revenue deficit results in distorting the distribution of purchasing power in the economy (for example, through persistent bloated payments to large bureaucracy and non-merit subsidies).

Fourth, there appears to be **delayed and cascading impact of increases in administered prices**, especially of major petroleum products and electricity on the price level. However, thanks to the intensity of competition, industry is forced to absorb the cost escalation, which manifests in subdued inflation and manufactured products. Therefore, the current price scenario does not provide any comfort of demand buoyancy in the industrial sector.

Fifth, the Government has been **progressively raising procurement prices of several agricultural commodities.** At present, twelve commodities are under the purview of procurement/minimum support prices. For example, paddy, wheat, jowar, bajra, gram, moong, groundnut, soyabeans, mustard, sugarcane, cotton, jute, tobacco etc. No doubt, the cost of production of agricultural commodities has been rising. But far more important is the growing pressure of farmers' lobby for fixation of higher and higher prices.

Minimum Support Prices				Annual % Increase	
For Crops (Rs./Quintal)	1980-81	1990-91	1997-98	1980-81-1990-91	1990-91-1997-98
Paddy	105	205	415	6.9	10.6
Wheat	117	225	510	6.8	12.4
Sugarcane	13.0	23.0	48.5	5.9	11.2
Cotton	304	620	1330	7.4	11.5
Jute	160	320	570	7.2	8.6
Wholesale Price Index					
Paddy	115	178	366	5.6	10.8
Wheat	111	172	334	5.6	9.9
Sugarcane	78	152	310	8.7	10.7
Cotton	87	146	347	6.7	13.2
Jute	120	283	359	11.3	3.5

Consequently, it is evident that the **rate of increase in procurement/minimum support prices has accelerated during 1990-91 to 1997-98 as compared to the decade of eighties**. The impact of this is visible in the movement of wholesale prices of such commodities. Once again, the small and marginal farmers are not the beneficiaries of the rising procurement/support prices, as they hardly generate marketable surplus of such commodities. In fact, being net consumers themselves, they often suffer the adverse impact of rising prices of primary articles.

Further, everytime there is a fixation of higher minimum support or procurement prices it serves as a new benchmark for open market prices. Consequently, the 'ratchet effect' on prices becomes operational. In fact, the system allows the motion of prices only in the upward direction. Besides, the government is either required to raise issue prices in the state-run ration shops (the Public Distribution System) or grant more subsidies, thereby imposing additional fiscal burden – both of which in the ultimate analysis are inflationary in nature. Indeed, this has become an inbuilt feature of the Indian price situation.

Last but not least important, the weak political governance and consequential ineffective administration are sure bets for rising prices.

Areas of Comfort:
The redeeming feature of the current price scenario as mentioned in the beginning, is the virtual absence of general inflationary psychosis. It would, therefore, not be very difficult for the government to rein in inflation within reasonable bounds. Indeed, there are **three other favourable factors:**

- First, the present foodgrains stock of over 28 mn. tonnes can help effective supply management through PDS;
- Second, the present forex reserves of about $24 bn. are adequate to meet India's import requirements for well over six months even after accounting for reasonable element of "flighty" capital. Therefore, whatever may be the supply deficiencies, as in the case of pulses and edible oils, substantial imports are possible;
- Third, the global price situation of commodities is extremely subdued, thanks to (i) lack of adequate demand for crude oil and petroleum

products, ferrous and non-ferrous metals and chemical intermediates, etc. (ii) excess capacities in several industries, and (iii) the overall contraction in the world economy and trade as an aftermath of Asian currency crisis.

It needs to be abundantly emphasised that **India at this stage cannot and should not emulate global standards of inflation** – *a la* the Maastricht Treaty for the European Union prescribing stiff standards of price stability, i..e. the inflation rate within 1.5 percentage points of the average of three best performing member countries.

This is so because, in the trade-off between growth and inflation we had earlier made a wróng choice by tightening monetary and credit policy during 1995-96, the results of which are still being experienced in terms of prolonged industrial deceleration. At a time when demands of industrial resurgence is so overwhelming, both the Ministry of Finance and the RBI will have to be extremely judicious in the use of policy instruments. Certainly, **this is not an opportune time for raising either the lending rates or restraining the flow of funds to the commercial sector.** Such an action would send wrong signals and be counter-productive, i.e. indeed, it would engender `stagflation' i.e. economic slowdown accompanied by further inflationary resurgence.

Concluding Observations and Policy Issues:

By way of summing up, we must emphasise that although the current price situation may have some distinguishing features of its own, there is **an intrinsic**

continuum in the Indian inflationary scenario. In retrospect, our experience of the last about five decades clearly shows that the pursuit of a sustainable relative price stability (i.e. inflation rate of less than 5% per annum) is an elusive goal. So also is the fact that Indian society invariably resists the phenomenon of double-digit inflation; in fact, there is "*a basic inflationary-aversion of the Indian society*", as so aptly described by Dr. Meghnad Desai.

We, therefore, strongly believe that an **average long-term inflation rate of about 7-8% seems to be an inevitable occurrence,** given the imperatives of securing a similar high level of real GDP growth on the one hand and phasing out the on-going deformities and rigidities on the fiscal system on the other, especially the remnants of administered pricing policy, including massive procurement of foodgrains and PDS, and the whole range of associated cross-subsidisation.

Even so, it would certainly be rash to be complacent about the current price situation. Of course, policy prescriptions galore in the sphere of both conventional and non-conventional areas when it comes to combating the rising prices. The critical evaluation of various policy issues is not within the purview of my talk. Nevertheless, I would like to stress **the urgency of a few major prescriptions,** some of which may be of a medium term nature in their scope. Thus, apart from what is already stated by way of *obiter dicta* earlier, particularly the supply management and the system of foodgrains pricing, we need to concentrate on the following:

- First, it is evident that outside the framework of procurement/minimum support prices, there is a virtual absence of **long-term agricultural policy.** From time to time, various experts have stressed the importance of the agricultural sector in providing stability for sustaining strong industrial growth and more equitable and balanced regional development. More importantly, India needs to usher in **fresh wave of `green revolution'** to substantially improve agricultural productivity. Given the basic limitations of expanding gross cropped area under cultivation, there will be **compulsive pressures on stepping up productivity** of practically every crop by atleast 30-50% in the next 5-7 years. For this purpose, `appropriate technology missions' can be evolved with a stress on high-yielding variety of seeds, assured irrigation, and appropriate use of fertilisers and pesticides.
- Second, there is so much to be done in the area of **fiscal consolidation** with a view to reducing the aggregate fiscal deficit to GDP ratio of both the Central and State governments. Often times, the discussion in this area is concentrated on the appropriate ratio of fiscal deficit to GDP ratio. While this is important, we should be **more concerned with the qualitative dimensions of fiscal management.**

Considering this, one feels constrained to suggest that **the new Finance Commission** should devote special attention to initiate an appropriate dialogue with both the Centre and the States in **dealing with the problems of phasing out their revenue deficits in a span of next 3-5 years.** However, if fiscal consolidation were to be achieved at the cost of **sacrificing capital expenditure,** it would have an **adverse impact on infrastructure development,** thereby aggravating the imbalances in the economy and problems of continously rising prices.

- Third, there has to be substantive efforts towards **raising the domestic savings ratio,** which is currently hovering around 25-26% of GDP. The challenges before the Indian economy is to achieve high real GDP growth of over 7% on a long-term basis. For doing so, in the coming decade there would be tremendous pressures on financing of infrastructure requirements, which are invariably of a lumpy nature in terms of capital investments and long gestation period. Once again, if there are going to be imbalances in the development of infrastructure facilities, it would be difficult to rein in consequential inflationary pressures.

- Last but not the least, **the quality and effectiveness of political governance and administration** is of crucial importance in inflation management. At this stage, this area leaves much to be desired.

In substance, the current resurgence of inflation is, no doubt, worrisome. But with better governance and skills of techno-managerial efforts, India can avert the dangers of double-digit inflation.

Relationship between output, money supply and inflation

Year	Money Supply (March end)	Real GDP	Average WPI (1981-82 = 100)
	(Rs. crores)		
1990-91	265,828	212,253	182.7
1991-92	317,049	231,983	207.8
1992-93	366,825	225,240	228.7
1993-94	434,407	239,145	247.8
1994-95	531,427	257,700	274.7
1995-96	604,007	276,132	295.8
1996-97	700,891	296,845	314.6
1997-98	820,299	311,984	329.7

	% Increase in			
	Money Supply (1)	Real GDP (2)	Inflation Rate (%) (3)	Inflationary Gap (%) (1-2) (4)
1990-91	15.1	5.4	10.3	9.7
1991-92	19.3	0.8	13.7	18.5
1992-93	15.7	5.3	10.1	10.4
1993-94	18.4	6.2	8.4	12.2
1994-95	22.3	7.8	10.9	14.5
1995-96	13.7	7.2	7.7	6.5
1996-97	16.2	7.5	6.4	8.5
1997-98	17.6	5.1	4.8	12.6

WPI = Wholesale Price Index

II

Understanding the phenomenon and its implications

By

Dr. Abhay Pethe*

To begin with, let me have a word about what is meant by price scenario or price structure and what is the function it performs. Simply put the configuration of all the prevailing prices of goods (consumables and assets) comprise the price structure. Now, price structure is like blood pressure and its existence is crucial in a positive way. *Only when it fluctuates and/ or increases or decreases beyond a point that it assumes a character of an ailment.* Carrying the analogy a bit further, the scenario by itself is symptomatic in character and indicative perhaps of a deeper malady which must be treated. The first essential function that the price structure performs is that it **enables us to evaluate the worth of a blanket comprising heterogeneous objects.** It should be obvious, that without evaluating the worth of different baskets there can be no comparision and without comparision there cannot be any rational choice. There are atleast two other important aspects of price structure/scenario that

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are of essence. The *relative structure* of prices and the *nature and rapidity of change.* The relative price structure determines the allocation of resources, whether for consumption or investment purposes. The usual presumption here is that if market forces are allowed to operate in an unhindered fashion then these decisions are *'optimal or efficient'.* The corollary is that any form of intervention (say of administered nature) lead to distortion. The relative structure thus defines the opportunity cost structure in an economy. Viewed in this way it becomes paramount to *get the prices right.* Indeed, much of the reforms process has to do with the design of institutions that would help precisely this objective. The way I have put it, there is a distinctly static flavour to the argument, but the dynamic aspect is even more important. The moment one is trying to work out the response of an agent to the 'rapidity' of price change, the dynamic element becomes crucial. Specifics like which commodities or group of commodities we are talking about with the underlying elasticities come into play. Further our responses are conditioned very importantly by our past experience including the past history of prices. For, we learn from history. It very importantly shapes our expectational frame. Expectations about what is likely to happen determines to a great extent our current actions and strategies. There is a consensus that modeling social learning and expectations formation are crucial, but how to go about it is as yet an open problem in economics. (There have been attempts, to be sure, e.g., Adaptive, Rational, Culture constrained expectations et al,). Expectations are thus tremendously important in the decision making process of the agents. After all – to state the obvious – agents take decisions on the basis not of truth but on the basis of what they believe to be true. Economists have woken up to the importance of expectations and the need to endogenise them within the framework of analysis. As an insider I may mention a lot of the economists attribute at least the *perpetration* of the contagion effect in the on going Asian crisis to `wrong' expectations.

What is Inflation?

Getting back to the price structure, when it changes it does not change homothetically. Different prices may not change in the same direction and even when they do, they may change at different rates. **It is only when the prices of reasonably large number of commodities increase in a sustained fashion do we term the process as one of inflation.** Now, since there are many commodities and hence many prices, we obviously need to use an index. This is a tricky process and inherently a bit arbitrary. Which commodities to use in an index and how much weightage to give to each component as well as which year to use as a base are all technical issues. However they matter and the choices made depend on the purpose for which the index is being constructed and is to be used. Currently we have many such indices constructed in India such as the CPI, WPI and GDP Deflator. The frequency of data used for their construction is different. **Conventionally, we measure**

inflation as a rate of change of WPI. Now, a look at the subgroup of commodities contributing to inflation and their weights, will explain the paradoxical situation where the inflation rate seems to be in control yet the perception is one of tremendous price rise. Thus whilst the overall index is useful for giving us a summary understanding the magnitude of inflation, it is equally worthwhile to look at the break up and extent of its spread. This is especially so if we are concerned with the understanding of the transmission mechanism (between fiscal or monetary policy and inflation) and/ or if we want to initiate policy measures to do something about it.

Why do we have inflation?

Economists differ about the reasons for inflation – as they do about most other things! Let us look at some of these without using the jargon of cost push, demand pull or structural theory. One could begin by classifying these reasons as emanating from the demand side or the supply side. Further we could try to ascertain if the shocks are `real' in nature or are `nominal' in character and further if they are transitory or permanent in character. Then there are the hoarders and speculators and of course there is the government – whose chief *raison dle etre* these days seems to be to serve a as a punching bag! I am not for a moment suggesting that they are unfarily blamed.

There used to be a popular model amongst the economists especially in the context of developing countries like India called the **Aghevli-Khan** model. This model showed how the inflation process was self feeding in nature. Simply put the explanation went as follows. Most governments in developing countries like India were forced to borrow a great deal from the Central Banks. This led to high levels of monetised deficits. This in turn meant that the *high powered money* in the economy went up leading to an even further increase in money supply. This set inflationary process under way. Inflation meant that nominal expenditures of the government rose (to keep up with real levels of expenditures) but the revenues did not rise to the same extent. This created a further wedge between revenues and expenditures leading to escalating deficits and the whole cycle repeated itself. Of late in India the automatic monetisation of government deficits has been stopped. However what has happened is that the government has been forced to borrow at market interest rates. Now since the riskless government paper sets up the base for other instruments as far as the interest rates are concerned. This has raised the entire term structure, leading to *crowding out* of the private investment.

Yet another popular explantion which continues to hold sway over many economists and policy makers is the so called monetarist position. *Inflation is always and everywhere a monetary phenomenon* it proclaimed. It sounds good but I have always found it difficult to *understand* it. After all the price of butter is a butter phenomenon, but this per se is not such an insightful comment. On the other hand if it is meant that *increase* *in money stock is a necessary and sufficient condition for inflation, then it may be shown theoretically that this is simply not true.* Indeed whilst there is certainly an important role for a central bank to play in an economy such a proposition – I believe – gives too much importance to monetary policy and puts an undue pressure on monetary authorities. But let me leave this here for any further discussion in this vein will lead us into deep and abstract theory, which I certainly do not want to discuss here today.

Let me touch upon some other related ideas which have been offered as explanations for inflation. One is the so called concept of **core inflation.** This concept has been used in two different ways. One it has been proposed that the dynamics of an economy – given the stage of development and institutions – entails a certain level below which the inflation may not be reduced. Core inflation is also sometimes referred to the subset of all the commodities which consistently contribute to the inflationary process and as such may be deemed to be fundamentally responsible – at least in the short run – for inflation. Inflation has also been rationalised as a result of a **conflict** between different groups in a society competing for a larger share of the pie i.e., income. This explanation has been proposed by economists who are political economists from the mainstream. Inflation is sometimes rationalised these days in terms of **bubbles, sunspots and self fulfilling prophecies.** It is here that I think it is important to be positive about combating inflation and not allow it to attain the status of *fear psychosis*. Myrdal in his Asian Drama made the point that charismatic political leadership was very crucial in such a context. Unfortunately today in the Indian case there is a lack of credible politicians, which ironically makes their task as policy makers even more difficult.

I personally like to think of inflation as a result of a convex combination of *real* and *psychological* factors. In looking at the reasons of inflation then, there are two things to be borne in mind first, that **it is crucial to distinguish between the *initiating* and *perpetrating* cause of inflation** and second, that there are no general causes which will hold for all places and times. The moral is obvious, dogma must give way to pragmatism.

Why does inflation matter?

It might come as a surprise to many of us, that whilst most people agree that inflation is public enemy *numero uno*, economists take all possible positions. Some believe that some amount of inflation is good, whilst others believe that in the long run it does not matter and yet others hold it to be bad without qualifications.

Some inflation is considered good for at least two reasons. In developing countries, the tax base is low and thus the government sources of revenue are constrained. Inflation allows the government to reap a benefit equivalent to imposition of a tax, especially if its contract obligations are in nominal terms. It leads to forced savings on the part of the relatively worse off who cannot be taxed. This is the softer political option, especially if it is possible for the government to evade the accountability and responsibility for inflation. This is seen in a sense, as a necessary evil. The other reason for considering inflation to be good is that there is a proposition that says that inflation and growth are positively related. The rationalisation is that with inflation the savers would be forced away from holding their savings in monetary form. This is because the value of money is going down. Thus this encourages savings to be held in the form of other financial instruments which gives fillip to capital formation and hence growth. The essential argument comes from economists like Keynes and Tobin and has most recently found an ally in Krugman who is an influential economist. In analysing the Japanese malady of recent times he has argued in favour of an inflationary regime (or at least one with inflationary expectations) so as to effectively avoid the *liquidity trap.*

The original argument was extended further to say that anticipated inflation at any rate does not matter, since rational agents will hedge their savings. But herein lies the rub, for, **the presumption of existence of hedging instruments and developed financial markets capable of risk management is simply contrary to facts, especially for developing countries.** Even in the simplest case of reaching wage contracts, such a hedging will be impossible for large segments of the society in a country like India with her large *informal* work force. Thus inflation even when fully anticipated *de jure,* in the *de facto* sense there is a very little countervailing action that is possible. Of course there seems to be a consensus that inflation is bad when it is highly *variable and volatile.* This clearly induces uncertainty that does no good at all from the point of view of decision making. Few contracts will be reached and those that will be reached will entail larger transaction costs. Stable regimes then are to be preferred.

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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FORUM OF FREE ENTERPRISE

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