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Inflation - A Challenge before Indian Economy

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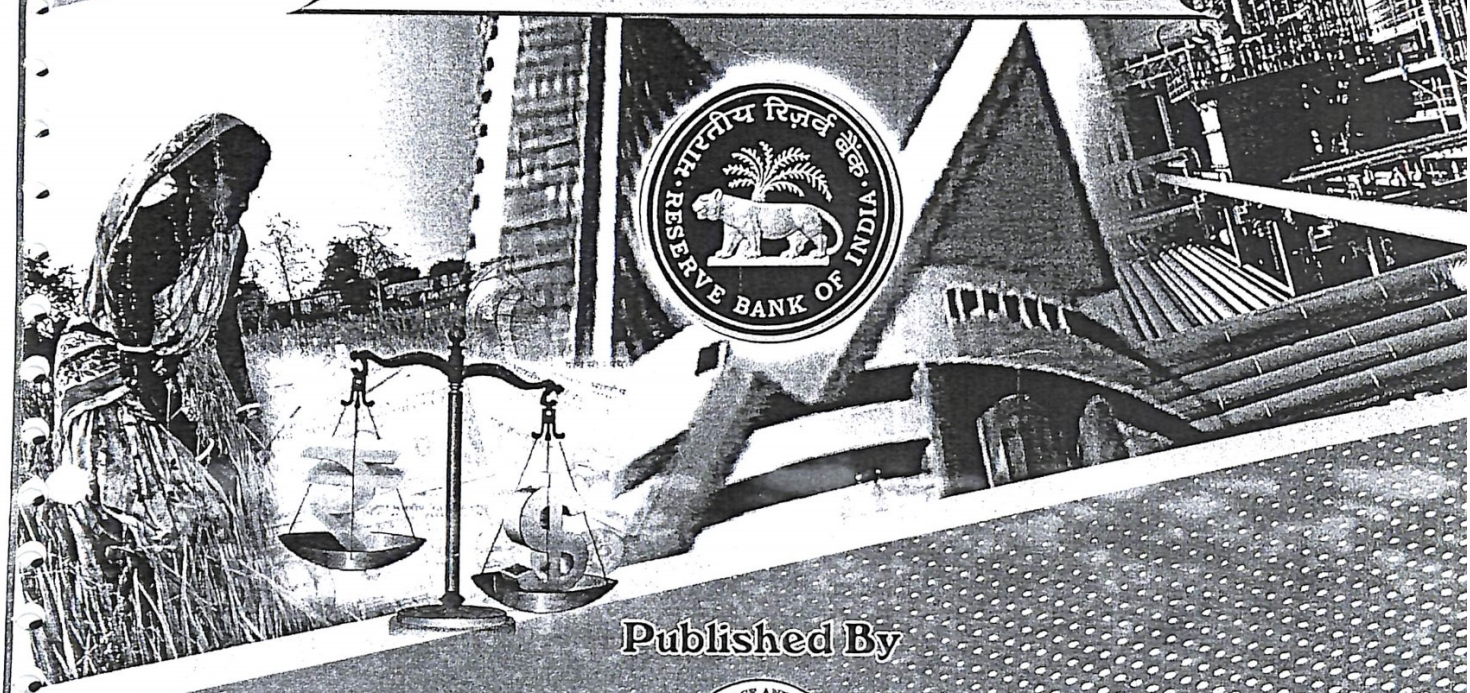

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INFLATION IN INDIA: PRESENT SENARIO OF INDIAN INFLATION

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ABSTRACT:

Inflation is, at the same time, one of the most dreaded and one of the most misunderstood of economic phenomena. We know from experience, combined with cogitation, that the prices of commodities will, over time, rise and fall, responding to the pulls and pushes of demand and supply. A failure of a particular crop or a flash fashion for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected glut in the production of onions will cause the price of onions to fall. These price movements are nature's way of signaling to consumers that they should consume less of the commodity facing shortage and more of the good in glut and to producers to produce more of what is in short supply and less of what is available in plenty. To even out these ebbs and flows of prices would be folly, as we know from countless examples of misdirected government interventions.

KEY WORD: *CPI, WPI, RBI, Monetary, Inflation etc.*

1) INTRODUCTION:

The prices of commodities fluctuate, responding to the pulls and pushes of demand and supply. A failure of a particular crop or trend for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected surplus in the production of onions will cause the price of onions to fall. Inflation, on the other hand, has little to do with these changes in relative prices of goods and services1. It refers, instead, to a significant rise in the general price level in a country over a long period of time. It is the opposite of price stability. In economics, price stability is not used in a rigid sense to mean price fixity. A modest increase of 2 to 3 per cent per annum in the price level is a compatible, sometimes even desirable, in the context of economic development. However, when the general price rise appreciates (say in double-digit figure) and experienced over a long period of time, it gets the dreaded name inflation2. For the common person, there is something threatening about the phenomenon of inflation, especially on those occasions when the rise in prices of goods is not matched by an equivalent increase in the prices of labour. Then what should be the tolerable limit of price rise. There is no clear- cut answer to this question because it all depends upon the economic circumstances prevailing in a country at a particular time. The Indian Committee to Review the Working of the Monetary System (S. Chakravarty Committee) recommended, as a general guideline, an increase in price of not more than 4 per cent4. Rangarajan regarded 6 per cent of inflation to be the outer limit. Tarapore Committee recommended 3 per cent level of inflation rate. Thus the acceptable range of inflation rate in India lies between 3-7 per cent.

2) FACTORS FOR RISING PRICES:

In general, the following factors are attributed to rise in prices:

- Area and production, which is dependent on weather and technology.
- Minimum Support Price
- Government policies
- Substitute product
- Demand/consumption
- Seasonal Cycles
- International prices

3) EFFECTS OF PRICE RISE:

The distortionary effects of inflation are injurious to the smooth functioning of an economy:-

1. Rising prices adversely affect the economic conditions of fixed-income groups, particularly wage earners. When prices are high, the value of money is low and vice versa. There is always a lag between price rise and money wage adjustment. Poor people in the unorganized sector are hit the worst because their income is not linked with price index. However, business firms gain during price rise because the money value of goods in their stock rises continually.
2. Inflation encourages hoarding of essential commodities, leading to speculation and generation of black money.
3. Fluctuating prices generate opposite effects on debtors and creditors. Rising prices prove beneficial for debtors at the expense of creditors. Thus, inflation discourages people to invest in financial assets. Conversely, falling prices make it difficult for debtors to meet their obligations. Price stability is a prime concern of the governments the world over.

4) HOW IS PRICE RISE MEASURED?

Changes in the level of prices are measured by means of index numbers. The index of prices includes a wide variety of goods and services which are essential for life8. In India there are five indices for measuring changes in the price level. Four of these are the **Consumer Price Indices (CPIs)**, which are specific to a group, or class of consumers and the one **Wholesale Price Index (WPI)**, which has an economy wide coverage and a higher frequency (Annexure I and II). The current series of WPI at base 2004-05 constitutes 676 commodities. There are three consumer price indices (CPIs) traditionally released at the national level to reflect the fluctuations in retail prices of goods and services pertaining to specific segments of population in the country. The basket of **CPI for Industrial Workers (CPI-IW)** based on 2001 included 120-360 items, **CPI for Agriculture Labourers (CPI-AL)** and **CPI for Rural Labourers (CPI-RL)** both with base year 1986-87 included 260 items. In addition, there is now the new series of **CPI-(U+R)** based on the year 2010 for both rural and urban areas and also combined has been introduced from January 2011 and includes 456 items.

5) INFLATION IN INDIA:

Before getting into the analytics of inflation, it is useful to have the basic facts on the table. India is right now in the midst of an inflationary episode that has gone on for 17 months. It began in December 2009, when the WPI inflation climbed to 7.15%1, it continued to rise, peaked in April 2010, at just short of 11%. Thereafter, it has been on a broadly

downward trajectory. What has caused some concern once again is that there was a small pick-up in inflation in December 2011 and also because the downward trajectory has been disappointingly slow. Before this 17-month run, we had one year of negligible inflation; but just prior to that there was another rally from March 2008 to December 2008, when WPI inflation hovered in and around 10%. Before these two rallies in quick succession, India had very little inflation for a dozen years. There were occasional months when inflation would exceed 8% and not a single month when it was in double digits during these twelve years of relative price stability.

For reasons of completeness it may be mentioned that independent India's highest inflation occurred in September 1974, when inflation reached 33.3%. Arguably our worst inflationary episode was from November 1973 to December 1974, when inflation never dropped below 20% and was above 30% for four consecutive months starting June 1974. Table 1 gives the full inflation data for WPI and food prices from 1971 to the most recent available.

6) AVERAGE TRENDS IN INFLATION (2000-01 TO 2011-12):

The range of inflation varied from a low of 3.3 per cent in 1999-2000 to a high of 7.2 per cent in 2000-01. During this period, inflation has had a distinct decelerating trend. In fact, even in 2002-03 when the country faced a severe drought, inflation remained moderate at 3.4 per cent. Moreover, 2002-03 was also marked by the simultaneous impact of several others adverse developments such as border tensions and high international crude oil prices. A hardening of international oil prices as well as domestic food prices responding to a deficient monsoon in the previous year fuelled a spurt in inflation in India during the first half of 2004-05. Inflation began to ease in the second half of 2004-05 under the impact of a combination of fiscal and monetary measures and weakening of south-west monsoon17. In 2005-06, WPI inflation eased to 4.3 per cent as compared to 6.5 per cent a year earlier.

The ten-year average of headline WPI inflation was around 5.4 per cent from 2000-01 to 2009-10.In this decade 2000-01, 2003-04, 2004-05, 2006- 07, and 2008-09 had higher inflation relative to the decadal average. The ten-year average inflation in fuel was around 8.9 per cent. The major portion of that was contributed by the high inflation of 2000-01. The years 2003-04, 2004-05, 2006-07, and 2008-09 also witnessed high inflation in manufactured products mainly on account of high prices of raw materials such as basic metal alloys and metal products, nonmetallic mineral products, and machinery and machine tools. The year 2008-09 was different from the previous three years as inflation in all the three sectors remained high on account of high international fuel and commodity prices. The year 2009-10 was an abnormal one due to global slowdown and unfavorable monsoon. Notwithstanding, the average inflation was 3.6 per cent backed by negative inflation in fuel.

The year 2010-11 was marked by strong inflation exhibiting persistence on the back of elevated inflation expectations, hike in vegetable prices with unseasonal rains post-monsoon and rising global commodity prices that resulted in significant cost-push and demand-pull pressures since December 2010. Drivers of inflation changed during 2010-11.Food products were the main drivers of price rise during April-July 2010, accounting for about two-fifths of increase in WPI. Their share declined during August- November, when non-food primary products turned out to be the main drivers. However, these price pressures spilled over to manufacture non-food

products during December 2010-March 2011, which accounted for 61 per cent of the price rise in this period.

The phase of softening of inflation was marked by a decline in the contribution of food, which again increased from February 2012 as prices increased sharply after the seasonal decline. The contribution of non-food manufactured products remained strong despite the deceleration in growth momentum. The contribution of fuel group to overall inflation remained high and significant throughout the year despite suppressed inflation from the administered prices of some petro-products, coal and electricity. Primary food articles inflation declined sharply during November 2011–January 2012, from above 10 per cent to negative territory, largely reflecting a seasonal decline in the prices of vegetables and a favourable base effect. However, prices rebounded significantly subsequently, resulting in food inflation reverting to double-digit levels by April 2012. The prices of protein-based food articles have remained persistently high since October 201122. As per mid-year analysis 2012-13, inflation as measured by WPI averaged 8.9 per cent for 2011-12.

Table No.1.

Annual Average Inflation Rate based on WPI

(Percent)

Year	Primary Articles	Fuel and Power	Manufactured Products	All Commodities
Weights (%)	20.12	14.91	64.97	100
2000-01	2.8	28.5	3.3	7.2
2001-02	3.6	8.9	1.8	3.6
2002-03	3.3	5.5	2.6	3.4
2003-04	4.3	6.4	5.7	5.5
2004-05	3.7	10.1	6.3	6.5
1st 5 Years Average	3.5	11.9	**3.9**	**5.2**
2005-06	4.3	13.5	2.3	4.3
2006-07	9.6	6.5	5.6	6.5
2007-08	8.3	0.0	4.9	4.8
2008-09	11.0	11.6	6.2	8.0
2009-10	12.7	-2.1	1.8	3.6
2nd 5 Years Average	**9.2**	5.9	**4.1**	**5.5**
Average 2000-2001 to 2009-10 (10 years)	6.4	8.9	4.1	5.4
2010-11	17.7	12.3	5.7	9.6
2011-12	9.8	14.0	7.3	8.9$

(Source: India, Ministry of Finance, Monthly Economic Report, December 2012)

According to the International Monetary Fund (IMF) statistics, 24 countries use WPI as the official measure to track inflation, whereas 157 countries use CPI for the same purpose. WPI is considered as most preferred measure of inflation in India due to its wider coverage, scope and frequency. WPI is compiled and released by Department of Industrial Policy and Promotion on monthly basis and weekly basis for primary articles.

7) DEMAND SIDE- MONETARY MANAGEMENT:

- Monetary Policy objectives : Price stability and Growth
- Money Demand Function reasonably stable
- Reserve Money is the operating target
- In 1990s Compositional Shift in Reserve Money
- NFEA is predominant component of RM
- Net RBI Credit to Government down
- Monetary Policy operational framework has changed
- Automatic monetisation of fiscal deficit that prevailed upto mid-1990s terminated
- Net RBI credit to Government moderated greatly
- Government debt sold in market at market-related rates
- RBI modulates liquidity through LAF
- Moving towards Fiscal Responsibility and Budget Management Bill (FRBMB) which envisages withdrawal of RBI from primary subscription of Government paper.

8) SUMMARY:

High inflation in India has become a major issue with both academics and policymakers. It is one of the biggest hindrances to growth and a major policy challenge for incumbent governments. This paper analyses trends in inflation over the past five years, particularly food inflation, and examines the demand and supply side factors behind surging food prices. It argues that demand for several food items in India exceeds their current supplies, and leads to high prices. It further contends that this demand-supply imbalance is attributable to structural inefficiencies, including distribution of food products. Pointing out that monetary policy responses are unlikely to prove effective in reducing food prices, the paper emphasises on the importance of increasing agricultural productivity and reforming retail trade policies for long-term results.

9) POLICY RECOMMENDATIONS AND CONCLUSIONS:

- The post-financial crisis period saw the government under immense pressure to tackle the inflationary situation while simultaneously facing the challenge of boosting the economy. The government could not progress on either front. This can be attributed to a possible misreading of the situation because of infirmities in the data used to arrive at policy decisions. There are three major areas in which data infirmities are reflected. (1) There is a discrepancy in inflation as reflected in the WPI and CPI. The RBI should discontinue using WPI as a measure of inflation; a better way forward would be to replace WPI with Producers Prices Index (PPI), which captures prices of both goods and services and is more representative for supply side management. For monetary policymaking, which is essentially demand management, global experience suggests that countries use mostly CPI. It captures the agents' expectation and demand channel. (2) The second problem is the use of IIP as a proxy to measure overall economic activity. Even though IIP captures only 16 per cent of the contribution to total GDP, it has been frequently used in macro modelling merely because IIP data is available on a monthly basis. (3) Quarterly estimates of GDP, particularly in the post-crisis period, have proved unreliable. This data has been revised a number of times in the post-crisis period. Strengthening the statistical capacity to ensure more reliable estimates of quarterly GDP data will help improve policy formulation.

- The consensus in recent literature is that stabilisation of the output gap helps lower inflation and hence, should be the major macroeconomic policy objective. However, the output gap is an unknown variable. Various methods have been suggested to estimate the output gap, of which, this paper found, the Kalman filter estimates yield an accurate result in the Indian context. There is still inadequate research on the estimation of the output gap in the Indian context. Further research on this will help calibrate policymaking more accurately.
- Inflation in the post-financial crisis period was created by both supply and demand shocks. The inability to co-ordinate fiscal and monetary policies resulted in the failure of demand management. On the fiscal side, political constraints imposed by looming elections impeded fiscal consolidation while the tiny incremental steps towards monetary tightening by the RBI failed to have an impact on demand.
- There was a failure to tackle the supply shocks as well. Monetary policy can be used effectively to dampen the effects of a supply side shock. Economic literature suggests that countries learn from earlier supply side shocks. Clearly, therefore, estimating the contribution of supply shocks to inflation will prove a useful instrument in policymaking. However, as this paper shows, such estimates need to look at the lagged effects of a supply shock since estimating it on the assumption of a simple contemporaneous relationship between inflation and the output gap would result in inaccurate estimates. Further research on the contribution of supply shocks to inflation in the recent post-crisis period is possible once the fully revised quarterly GDP data are released.

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