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Top Article: Ease The Pain

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As economic conditions have swung from high inflation to declining growth back to rising inflation during the past year, economic managers have been scrambling to adjust their policy stance to a rapidly changing economic scenario. At this time last year the price of crude oil had risen to an all-time high of $147 per barrel, following a spike in world food prices that had sparked food riots in several countries. The headline inflation rate in India was peaking at close to 13 per cent. The government and the Reserve Bank of India (RBI) were both focused on that challenge.

Then the scene changed dramatically from September 2008 onwards. The collapse of Lehman Brothers marked the onset of a massive global economic crisis. With recession in the developed countries the price of oil and other commodities collapsed, triggering fears of deflation. In India, a steep decline in export demand and domestic liquidity reduced growth from over 9 per cent to 6.7 per cent. Inflation had fallen to 0.7 per cent by end-March this year, and turned negative by end-June.

These developments called for a swift reversal in policy. The RBI quickly intervened to reverse the sharp decline in liquidity and reduced policy rates to induce growth. On the fiscal side, the embarrassment of a large deficit far exceeding the Fiscal Responsibility and Budget Management target now turned out to be a welcome fiscal stimulus and was beefed up through further stimulus packages to restore growth. Growth is also the main thrust of the 2009-10 federal budget.

The government and RBI have also been very careful to ensure that large government borrowing will not crowd out private investment, the main growth driver. Borrowing is likely to be trimmed through significant divestment of public enterprise equity. Three quarters of total borrowing will be completed by September, making room for the private sector during the busy season starting October. Higher external borrowing from the World Bank and Asian Development Bank will also ease domestic credit pressures. Finally, and most important, a part of the government draft on the capital market is being offset through de-sequestering of Market Stabilisation Scheme balances and RBI open market operations to increase liquidity.

Now the economic scenario is again shifting sharply, calling for yet another switch in the policy stance. With a faltering monsoon and rising food prices, the opposition has already started agitating about inflation. Though the headline Wholesale Price Index inflation rate remains low, the Consumer Price Index for agricultural and rural workers is already well above 11 per cent. This is the largest and poorest consumer group, with little capacity to absorb rising prices. But their cost of living especially the price of food will rise even further in the months ahead as the full impact of a weak monsoon hits us, leading to considerable distress in the countryside. Drought conditions have been declared in 141 out of around 600 districts in the country and prices of grains, pulses and vegetables have already started spiking. Globally, too, the prices of pulses and sugar have been rising sharply, factoring in adverse market conditions in India, and crude prices have firmed up to around $70 per barrel.

Clearly the policy focus must now shift from growth back to inflation. Indeed, the RBI has reacted fast. Its second quarterly review of July 28 took note of building inflationary pressures and the need to manage liquidity accordingly. A gradual reversal of its growth focused 'easy money' policy of the first quarterly review has already started. There has been no further easing of policy rates or the cash reserve ratio. Also, contrary to expectations of large-scale deficit monetisation through open market operations, this is now likely to be limited to only Rs 80,000 crore, keeping a tight leash on liquidity growth. However, the main policy intervention to contain distress and drought-driven inflation has to focus on supply management in foodgrains and relief operations.

Timely releases from 53 million tonnes of government food stocks can contain the rise in food prices till the next harvest provided hoarding can be prevented. The planned supply of cheap grain to poor families can be accelerated along with the proposed expansion of NREGA to minimise distress. If that proves administratively difficult, state governments should quickly initiate drought relief operations in affected districts, including food-for-work programmes, assured supply of drinking water, fodder provision and protection of livestock.

Can such a strategy actually work? Though the incidence of poverty usually shoots up in years of drought, sceptics were surprised to find that the proportion of poor people remarkably came down during the severe drought of 1997-98. The government had then followed a strategy of tight liquidity, combined with timely release of foodgrains, tight control on hoarding, and large-scale relief operations in the then worst affected states of Rajasthan and Maharashtra, similar to the approach outlined here. It's a lesson worth revisiting.

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