To Curb Or Not To Curb

Traditional inflation fighting methods may land us in stagflation

Sudipto Mundle

The price of crude oil, silver and other commodities dipped sharply the day after the RBI raised policy interest rates by a further fifty basis points last month, and it was accused of being behind the curve, dealing with yesterday's problem, etc. However, nowhere in the world can the monetary authorities, or anyone else for that matter, predict at the time of announcing a policy what the global markets will throw at them the next day. Besides, the slight moderation in recent weeks notwithstanding, high inflation remains the number one challenge for macro-economic management at present. So the RBI is quite right to focus on this. But the real worry is that it may not have the required tools to contain the kind of inflation we are experiencing.

The phenomenon of inflation is more complex than is commonly understood. While inflation manifests itself as a rise in the general level of prices, its sources and causes may vary quite widely. In the present episode, while all prices have been rising, it has been led by different groups of commodities at different times during the past year. A year ago, inflation was being led by food prices. Later in the year, it was primary non-food items fuels and minerals that led the price rise, though vegetable prices also saw a spike in the winter. During the last few months, manufactured products have led the rise in prices. Thus the sources of inflation have varied greatly during the year, and their causes could also be quite different.

To understand this, it is useful to think of the economy as consisting of three broad segments. The first is one where supply is relatively inflexible in the short run, and prices adjust to equate demand and supply. In agriculture, for instance, supply is fixed once the crop has been harvested. When that supply is short compared to demand, prices rise. When the supply is in excess of demand, prices fall.

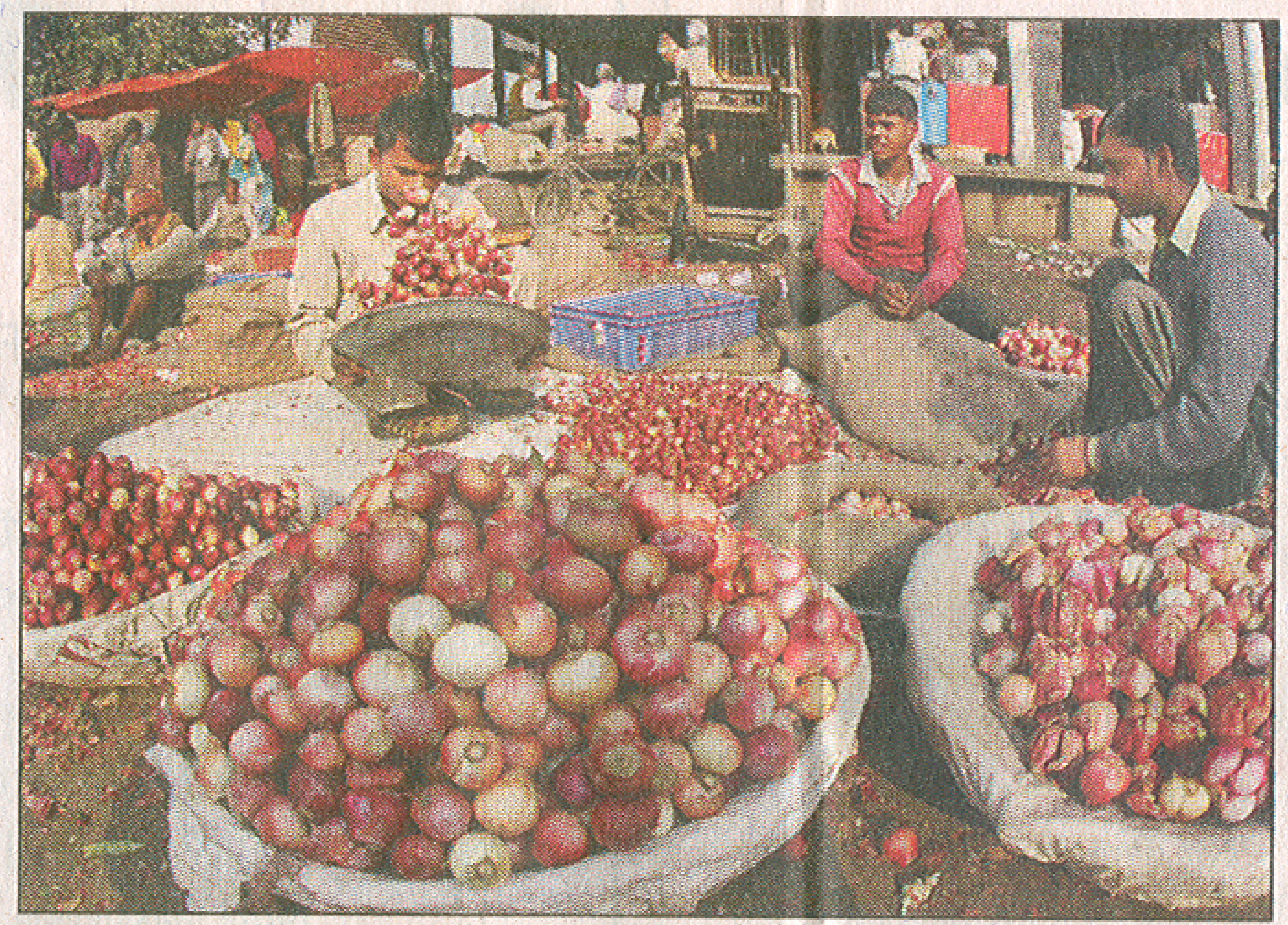
The second segment is one where the quantity of supply is flexible and adjusts to the level of demand at given prices. The prices themselves are less flexible, and formed as a mark-up over costs. The size of the mark-up reflects the pricing power of market leaders, or what economists call the degree of monopoly. In highly competitive markets, or in the downturn of a business cycle, margins are low. Conversely, prices tend to rise in the upturn of a business cycle, or when competition is weak. Prices will also rise when costs rise in this segment of the economy. Cost push inflation, as distinct from demand pull inflation in the first segment. The manufacturing sector is a typical example of such price formation.

> The phenomenon of inflation is more complex than is commonly understood. While inflation manifests itself as a rise in the general level of prices, its sources and causes may vary quite widely

In India there is a third segment, the administered price segment, where prices are formed by government order. Large swathes of the economy, which are still dominated by public enterprises, are part of this segment, e. g. the oil companies which adjust prices only when permitted to do so by the government.

Of course, the adjustment of administered prices is often a delayed reaction to underlying market forces, the price of hydrocarbons again being the obvious example. The formation of some prices is also a hybrid phenomenon, as in the case of food grains like rice and wheat. There is a threshold price, or support price, which is administered by fiat. However, actual prices can rise above this level if there is a sharp shortfall in supply, e.g. because of a drought, and market forces come to dominate as in the first segment.

Another complexity is added by international trade, where prices of exports or the costs of imports are determined by global trends. This is again illustrated by the price of oil. But there are many other products where price changes are also driven by global trends. Cotton, rubber, iron ore, gold and silver are all examples of commodities where large increases in domestic prices during the past year have been highly correlated with increases in international commodity prices.



Hitting people where it hurts, but what's the answer?

The main policy tools that the RBI has at its disposal, such as policy interest rates, cash reserve ratio, open market operations etc are effective in managing the level of demand, or in containing inflation arising out of demand-supply imbalances. They are also effective in dampening the business cycle, and to that extent, pricing power in the cost plus mark-up segment of the economy. Much the same applies to fiscal policy implemented by the finance ministry.

But neither of these institutions can do much to control inflation if it is of the cost push variety, especially if the costs are being driven by global price trends. Indeed, if demand containment measures are deployed to control cost push inflation, they could well end up hurting growth without much effect on inflation – stagflation.

This is a phenomenon the world first experienced during the 1970s when the oil shocks triggered inflation across the world. The monetary and fiscal authorities adopted traditional measures to control inflation via the containment of demand, but they only ended up hurting employment and growth without controlling inflation. It is important to guard against the risk of attempting to fight inflation, and ending up with stagflation.

The writer is emeritus professor at the National Institute of Public Finance and Policy, New Delhi.