CONTROL OF INFLATION IN INDIA

Inflation is a common phenomenon in a fast growing economy (Past evidences have shown that inflation rates were higher in developing countries). In fact, inflation rate of about 3-4 percent (Optimum range recommended by elite economists, Chakravarthi committee as well) is considered to be optimum for a booming economy. Sometimes, like in India, because of its rapidly growing economy, inflation rate crosses this range because of the uncontrolled price rise. Sometimes, the measures taken by the government won't yield because of the uncontrolled black-marketeering, hoarding, international price situations (like that of crude oil), vagaries of monsoon (drought leads to shortage of food production and supply). Government measures like change in monetary policy (Various rates like repo, reverse repo, CRR, Bank rate etc) yield only in the long term. The reason to worry about is not the inflation per se but its consequences.

SOME OF THE CONSEQUENCES OF UNCONTROLLED PRICE RISE ARE:

1) EFFECT ON PRODUCTION:-

Like inflation production of a good or providing a service is an interdependent and intricate process. If a good has to be produce, various inputs should be available to produce and sell it to the final consumer. Let me explain with some examples that how price rice in just one sector will have its adverse effects on all dependent sectors, contributing to an aggregate price rise of the final product.

"When there is inadequate rainfall, it could lead to a condition of drought. A condition of drought leads to decreased production of a crop; let us take it as sugar-cane. When the yield is less, supply goes down. Sugarcane is the raw material for sugar industries. When the raw material has been purchased at a higher cost, obviously the cost of production of sugar goes high thus leading to increased price (inflation results as sugar is one of the inflation sensitive food items). The byproduct of the sugar industries, molasses (used to make alcoholic beverages) and baggase (used in paper making) will also cost high. Thus the production of alcoholic beverages and paper is affected. When cost of the paper goes high, the production of the newspaper you read daily is affected. (These are a case of both demand pull and cost-push inflation, which I had explained in the previous posts on inflation. Because one end product of a sector acts as raw material for other industry)

Let me give another dimension to this. When the price of food items goes high, people start sleeping without satisfying their hunger (There are about 27 % BPL population in India, most of the labourers in India work in Agriculture sector. Overall, the work force of India consists of a huge chunk from unorganized sectors, whose salaries are not guaranteed as that of

government employees). When people are hungry, they are also angry. Workers of an industry whose income is not enough to satisfy their basic needs demand a hike in salary, strikes happen, lockouts happen. As a result that industry faces labour shortage, shortage leads to high demand, high demand leads to price rise (in this case labour becomes costly. Therefore cost of production rises resulting in price rise."

This is just one example; I am of the opinion that this one example itself is too intricate. If we want to solve the above problems (Inflation is always cause and of many factors) the root cause should be addressed. The root cause here is inadequate rainfall, about which no economist gives attention. Now you can think how really interdependent and intricate the phenomenon of inflation is.

2) INEQUALITY:-

Like production inequality is also an intricate phenomenon. If we factor in inflation, inequality is both the cause and effect of inflation. The ones who are affected by price rise are the one who are already poor and who work in unorganized sectors. The one who cause the price rise, in most of the cases are those who have enough wealth with them (People who practice hoarding, who evade taxes, who have black money, who are black-marketers etc). When there are favourable conditions for such practices, such unscrupulous traders make money and the poor people who can't satisfy their basic needs with their meager income become poorer. This also affects the psychology of vast majority of people, who start venting their frustration and aggression through the anger they show on the policies of the state.

The solution in this case is curtailing the unscrupulous practices. Now you might have understood how mighty and interlinked the phenomenon of price rise is. The Government has taken some important steps in this direction. Like;

A) Prevention of money laundering act (2002, Amended in 2009).

B) Various measures taken to prevent tax evasion by Income tax department.

C) The Essential commodities act (1955, Amended in 2006): to prevent black marketing.

Now I shall discuss some of the measures taken by the government to target inflation.

The Government of India has worked out a wide range of measures to control inflation and to ensure stable conditions as well as to prevent speculators from taking an undue advantage of the conditions of scarcity.

1) DEMAND MANAGEMENT

The government targets the demand side of inflation mainly controlling the money supply in the country. The price policy of the government has changed overtime .The policy has relied on fiscal and monetary measures with a view to check the demand of the general public for goods and the services (by decreasing the money with them).

A) FISCAL MEASURES.

The Indian government has always tried to control its own expenditure and keeping the revenue and fiscal deficit minimum. In 1984, the Government of India announced a package of programmes to curtail public expenditures, to postpone recruitment to government jobs etc. But the measures were not effective. Instead the governments (both central and state) have always adopted a policy of deficit budgeting, revenue deficit and fiscal deficit. Thus instead of checking prices, government policy has actually pushed up prices.

But since 1990-910 the need to reduce fiscal deficit has gained importance. The budget of July 1991-92 took the first decisive action to limit the fiscal deficit from 8.4% in 1990-91 to 6.2% in 1991-92 and to further 3.1% in 2007-08. (This was in compliance with the conditions imposed by IMF). The Fiscal policy for 2010-11 is being guided by the principles of gradual adjustment from the fiscal expansion of 2008-069and 2009-10 (Because of global financial crisis). The adjustment path is being so calibrated that it would not affect the revival process and at the same time stabilize the debt to GDP ratio of the Government in the medium term. In the Medium Term Fiscal Policy Statement of 2009-10, the Government had enumerated the roadmap for fiscal consolidation during 2010-11 and 2011-12. The Government is adhering to these commitments made in July 2009 and has also benefitted from the recommendations of the 13th Finance Commission on fiscal consolidation. Accordingly fiscal deficit in BE 2010-11 has been reduced to 5.5 per cent of GDP. This correction of fiscal deficit is attributed to reduction in total expenditure by 0.6 per cent of GDP (from 16.6 per cent in BE 2009-10 to 16.0 per cent in BE 2010-11), increase in gross tax revenue by 0.4 per cent of GDP (from 10.4 per cent in BE 2009-10 to 10.8 per cent in BE 2010-11) and increase in non debt capital receipt by 0.6 per cent of GDP (from 0.1 per cent in BE 2009-10 to 0.7 percent in BE 2010-11). All the above numbers are with reference to the revised GDP numbers.

B) MONETARY MEASURES:

This is done by RBI; it involves extensive use of general and selective credit control measures. In general, RBI uses its monetary policy to achieve a judicious balance between the growth of production and control of the general price level. RBI uses Bank rate, CRR, SLR and open market operations to increase bank credit and expansion of business activity (during recession) or to contract bank credit and check business and speculative activity (during inflation).

Any increase in CRR, Bank Rate, SLR, reverse repo, repo rate results in decreased money with Commercial banks thus money supply in the country decreases and vice versa. Decreased

money leads to decreased demand and thus eases the rising prices. [To understand this better read my post on “Important rates of money market”, I have dealt with the basics of these rates in that post].

In July 2010 RBI announced that it would update the monetary policy about 45 days after the quarterly review to respond faster to changing domestic and international economic scenarios. The RBI said that such formal mid-cycle announcements would take out the surprise element arising from an off-cycle rate decision as was the case earlier (Although scheduled policy announcements were made once in a quarter, the RBI had intervened at times when situations demanded a policy change). The present RBI governor, D V Subbarao had said that mid-quarter reviews are intended to communicate our assessment of economic conditions more quarterly.

The former governor of RBI has supported the RBI’s decision of increasing the various interest rates. He said that it is a long term measure to contain inflation and promote healthy growth of the economy.

This ends demand side management. The supply side management will be discussed tomorrow. With that the discussion on inflation will end.