Inflation – Some Diagnostic Comments

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Anyone who gives advice to Narendra Modi and the new government about to be formed (there being no dearth of such advice) states that the first task of the new government would be to tackle inflation and bring down prices. As a piece of advice this cannot be faulted because the fact is that run-away prices of essential commodities, especially food stuffs, have hurt the common man so badly that this became one of the major factors for the defeat of the Congress. The previous government's reaction to such price increase was to adopt wholesale the Karunanidhi-Jayalalitha-N.T. Rama Rao formula of distribution of a certain quantity of grain to poor people either free of cost or at a subsidised price which approximated to free supply. This was by way of a dole which is unexceptionable, provided that it forms the part of a universal, well thought out and crafted policy of social security which not only provides such relief but also works out the scheme to the last detail, including how the cost of the subsidy will be met. Europe had a social security system in place when Bismarck was Chancellor first of Prussia and then of Germany, for whose unification he was responsible. Even the United States of America, by no means a socialist country, has an effective social security system in which the needy are given a dole or relief and the indigent are given a form of food subsidy through what are called food stamps or coupons. Deductions from wages and salary are made to cover the cost of social security so that, by and large, the system is self sustaining. Because in India the so called food security is not based on the subsidy portion being paid for by those who are employed and are relatively better off, the entire burden falls on the exchequer, obviously at the cost of development programmes. This is not a programme of social security but rather one which beggars the entire nation. Certainly such a programme is not aimed at curbing inflation but rather at very slightly mitigating the hurt caused to the poor by rising prices. In any case distributing doles can only be a very short term measure because at the end of the day the beneficiaries of dole have no greater access to gainful employment and, therefore, become as dependent on the dole as a drug addict depends on narcotics.

There is a belief that if government takes coercive action inflation can be curbed. Let us, therefore, examine what causes inflation and then try and attempt a policy which could either stop it or negate its harmful effects. Ultimately price boils down to the relationship between demand for a commodity or commodities and their supply. If there is equilibrium then prices would remain stable, if there is a glut the prices would fall and if there is scarcity the prices would rise. Equilibrium can be disturbed in many ways, one of which is obviously hoarding, holding back from the market or otherwise using a monopolistic or oligopolistic position to keep the market deliberately starved of the commodity in question. In the case of manufactured goods the State can regulate the market in such a way that artificial scarcities can be kept under control, especially by cracking down hard on any form of cartelisation. What is more, by insisting on the manufacturers prescribing a maximum retail price, with action against them if the price is pegged artificially high, government can certainly and effectively control the movement of prices. Similarly, if traders hoard food grains and other items of food consumption government can, to a limited extent, force them to bring the goods into the market so that there is a levelling of supply and demand. This is within the realm of the possible and certainly government should intervene if the market is brought under artificial stress through hoarding.

The producer, that is, the cultivator of agricultural goods for consumption, faces a multiple of situations in which he can be responsible for both surplus and shortage. The difference between him and a manufacturer in the secondary sector is that the scale of operations in agriculture is very small at the individual level because the vast majority of Indian farmers are small land holders, whereas the industrial manufacturer has to operate on a much larger scale. The cumulative effect of how all the farmers behave can have an impact on the market, but an individual farmer by himself can neither create a glut nor a scarcity. The farmer, largely dependent on rain fed agriculture, is at the mercy of the monsoon and a good, timely monsoon gives him a bumper crop, an erratic monsoon brings down production and drought at the wrong time can virtually destroy the crop. Other factors which can affect production are untimely heavy rain, hail and frost and as happened in the Rabi season of 2013-14 in Madhya Pradesh and many other parts of the country, unseasonal rain and hail when the wheat crop was about to ripen virtually destroyed the entire wheat crop. Obviously this has created a scarcity in the market and has pushed up wheat prices. Directly government can do nothing to stop this kind of price rise because not even Narendra Modi can control the monsoon.

The farmer, especially because his holding is small, does not have much staying power and, therefore, when his crop is ready and harvested he has to sell it in the mandi. That is the time when the mandi is flooded with the crop in question and, therefore, this creates a situation of excessive grain, etc. Here government can and does intervene by stepping in to purchase the grain at what is known as the floor price which would give a reasonable return to the farmer. As the consumer price index rises the floor price has also increased from time to time so that ultimately the cost of food stuffs also rises, which is only fair to the producer. However, if the income level of the consumers remains static the increase in price affects them and fuels food based inflation, which is what hurts the average Indian consumer. Our policy of food grain purchase, the storage of grain in warehouses owned by the State Warehousing Corporation, the transfer of the grain to the Food Corporation of India (FCI) to form a buffer stock and the use of the buffer stock to keep grain prices stable are all part of a programme of government intervention to keep prices under control. Unfortunately our warehousing capacity is still very limited and the buffer has been used more to guard against a year of scarcity rather than as a price stabilisation mechanism. Ultimately it has degenerated into a programme of distributing doles in the shape of cheap or free food grains, against which programme there is a great deal of criticism because FCI has a tendency to release old and rotting stock which does not benefit the consumers and brings government into disrepute.

Ideally our agricultural policy should aim at maximising production so that at least on the supply side there is no shortage. We need a huge expansion of our warehousing capacity and from these warehouses there has to be a steady release of commodities into the market so that at no time is there either a glut which artificially pushes down prices, nor a shortage which similarly pushes them upwards. Therefore, both as a means of price stabilisation and as one which ensures a fair price to the producer because he is not forced to unload all his product at the time of harvest, the new government must evolve a well thought out of policy for agriculture, including production, warehousing, steady release into the market throughout the year, plus value addition through agro based industry. Though this would form part of the overall agricultural policy, it would also be an important instrument of price stabilisation and should form a part of a long term strategy to bring food grains driven inflation under control.

In a totally monetised economy which works through the banking system a well known means of keeping prices under control is to regulate money supply in the market. When the economy shows signs of stagnation interest rates are lowered, money supply increased, consumption encouraged and the demand for goods helped to rise so that there is a simultaneous encouragement to produce. The reverse is done if the economy is under inflationary pressure. Because the entire economy is totally monetised marginal changes in the interest rate can have a strong impact on the economy either way. Our economic planners, bankers and framers of fiscal and monetary policy follow the model of the developed world and use the bank rate as a means of trying to control inflation. The result is a resounding failure for the simple reason that India is still not a monetised economy in that it does not work only through the banking system or the formal capital market. Without attempting to gauge the size of the parallel economy in which money supply moves through underground channels (popularly called black money) and in the retail market through an informal credit system, the fact remains that it is so large as to be almost as powerful as the formal system. The bank rate and money supply available through the mechanism of the banks have absolutely no effect on the parallel market. What the bank rate does is to make the supply of money to legitimate business and industry, which accesses the banks for investment capital and working capital, so expensive that business and industry can no longer compete in the world market because its capital costs have gone through the roof. This reduces legitimate investment, slows down industrial expansion, does not encourage the creation of productive jobs and subjects the economy to the twin evils of unemployment and increasing prices. This is a classic scenario of inflation combined with unemployment. In fact this is precisely the kind of situation in Britain which gave rise to the economic theories of Lord Keynes. This is what led to Keynes advocating the injection of capital, if necessary through deficit financing, to rejuvenate the economy, increase production and create more jobs. His theory predicated that the inflationary effect of pumping money into economy would be taken care of by job creation and higher wages. This was successfully used by Roosevelt at the time of the Great Depression to revitalise the American economy and was the mantra in Western Europe, where all the governments were prepared to face a slightly higher inflation figure, provided that unemployment was reduced to the absolute minimum.

Keynesian economics is still relevant to India, especially because we have, over the past few years, used deficit financing to support unproductive doles rather than as a means to kick start the economy and have tightened up money supply for genuine investment so that industrial expansion is reduced. There can be no more suicidal policy than this, because returns on capital which can take care of deficit financing over the long run are not available and instead the inflationary pressure of more money in the market for unproductive activity keeps on mounting. A certain degree of upward movement of prices can be absorbed without causing harm if there is a parallel growth of the economy, rising gainful employment and better wages and higher incomes across the board. In a relatively high wage economy the percentage of income spent on bare essentials, especially food stuffs, is probably a small fraction of the total income, certainly less than ten percent of such income. The balance of income goes to pay for housing, clothing, education of children, transportation and small comforts and luxuries. Here if there is a marginal increase in food prices it can be absorbed by minor adjustments in expenditure out of the major part of the income which is not spent on food. In India, on the other hand, for those who are economically weak or are in the lower income bracket, anything between 70 and 80 percent of the total income may be spent on food. Certainly it would not be less than 60 percent for a slightly better off family. Such a family has no cushion and, therefore, cannot absorb increased food prices by adjusting its other expenditure. Such a family faces starvation if food prices rise and it is this huge section of our people which is really hurt by the inflationary pressure of food prices. The percentage of such people would probably be around 40 percent of the total population which, in absolute numbers, would be anything between 48 and 50 crores, that is, double the population of the United States. It is this part of our population which is looking to Narendra Modi for relief and it is the monster of inflation as it affects these people which Narendra Modi will have to tackle.

De-hoarding, locking up black marketeers, food subsidies, even free grain are short-term measures and will provide minor relief as was done by the previous government. The only thing which will enable India to tackle inflation is a massive upsurge in our economy which causes business and industry to expand, creates millions of new jobs which are productive and raises median income levels so that as a proportion of the total income of a family, the share of expenditure on food falls substantially. A family which spends 60 percent plus of its income on buying food has no cushion to deal with food price driven inflation. If the same family spends 30 percent of its income on food because the income itself has doubled, then it does have some cushion to deal with increased food prices. That is what the new government must aim for. In an expanding economy there is bound to be some increase in demand and if supply does not keep up there will be some rise in prices. A higher income level will negate the harmful effects of the price rise, whilst simultaneously encouraging increase in supply of the commodity through greater production. A relationship in which on the supply side there is plenty so that scarcity driven inflation does not occur and on the demand side there is an incentive to produce more is the ideal situation for which the new government must strife. Let is not lose its way in a swamp in which the only objective is to try and curb inflation because that is a path which leads to nowhere.

The purpose of this essay is not to give a magic solution for dealing with inflation but to caution the incoming government that inflation by itself cannot be tackled in isolation. This has to be part of an effort in which the economy is looked at holistically, industry enabled to expand and create jobs, the people are trained in skills to be able to benefit by the new jobs, agriculture receives the kind of attention which will bring in more capital, increase crop yields, bring more agricultural commodities into the market and yet protect the interests of the cultivators by ensuring a fair price and generally add to the buoyancy of the economy. For this purpose it is permissible, in fact may become imperative, to revert to orthodox Keynesian economics in which, if necessary, deficit financing is used to kick start the economy, create jobs, raise income levels and then use the returns there-from to restore the fiscal balance. In theory this sounds fine but the real challenge before the new government is how to be objective enough to be able to adopt the right measures to achieve the above, without losing its way in panic and entering into the kind of bye-ways into which the old government wandered. In other words, the new government needs wisdom in deciding the trajectory of the economy and then firmness to follow the trajectory single mindedly. That is the way forward, that is what will bring inflation under control. For this the government must have the courage to withstand populist pressures.

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