ORF Report

"Avoid Knee-jerk Reactions to Tackle Inflation"

The Observer Research Foundation organized a roundtable discussion on *Rising Inflation and Government Policy Responses* on April 14, 2008. The roundtable, chaired by Dr S. Narayan, former Economic Advisor to the Prime Minister, saw an eminent panel* of economists, politicians and academics engage in a lively—and, at times, heated discussion—on an issue that has come centre stage not only in India but globally as well.

With India's annual inflation rate rising to a near four-year high on a point-to-point basis on the back of rising food prices, the search for policies to combat the price rise poses unusual challenges. The nature and causes of the current spiraling inflation in India has become a subject of intense debate, primarily because of the ostensible role of `imported inflation' in driving the domestic prices north. Issues like poor performance of the Public Distribution System, high and rising levels of oil prices and questionable management of our food economy figure among the reasons. It has also raised doubts among some policy makers about relying on the Wholesale Price Index (WPI) as an instrument of measuring the price fluctuations.

Initiating the discussion, Dr Narayan raised a number of questions about the poor quality of the data (leading to frequent and sharp upward revisions between the provisional and final numbers), reporting delays leading to unwarranted spikes in the numbers from time to time, and the failure of secondary effects of rising commodity prices, especially of oil prices, not reflecting on the inflation numbers which, he said, could mean that the actual rate of inflation might well be much higher than was reported presently.

Why was none of this foreseen earlier, he asked, and if it was, would it not have helped if the tariff reductions now being effected had been made at the time of the Budget. The general belief is that the present bout of inflation is largely supply driven and due to global factors. We could have managed the supply side better, especially in the case of cereals such as wheat and rice, he said. He cited the case of Bangladesh managing its supply side cleverly in the last 8-10 weeks resulting in marginal reduction in the prices. He said while it was not difficult to understand the rise in prices of commodities which were imported or attracted high tariffs, like oil seeds and pulses, it was difficult to fathom the steep rise in the prices of vegetables.

If the answers lie on the supply side and our immediate neighbours, Pakistan and Bangladesh, have shown some success in augmenting supplies, why aren't we seeing similar supply side interventions

happening in agriculture here, he asked. At a recent agriculturists' forum, the Prime Minister had observed that small and marginal farming was becoming unviable in this country. If that is indeed true, it could impact about 300-400 million people in India with serious repercussions for the country, he said.

Following Dr Narayan's remarks, Dr Jayshree Sengupta of ORF made a brief presentation on inflation. Titled *Facts and Figures on Inflation,* it pointed out that though inflation was presently at a 40-month high of 7.4% (since gone up to 7.61%) this was not the first time India had experienced high inflation. India saw double digit inflation in 1967-68, 1973-74, and then again in 1976-77, 1979-80. But in the past inflation was mostly due to drought and fuel price hikes. What is different about the present inflation is that it has coincided with soaring world commodity prices. World metal prices have gone up, crude oil prices are close to $112 a barrel (it subsequently went up to $ 124 a barrel, though it has since come down to $118), the area under wheat has shrunk worldwide due to diversification of land for bio-fuel production; world production and exports of wheat have declined and there is rising demand from increased population and income. The net result is a rise in food prices across the world. In a nutshell, there is a supply-demand mismatch in food.

At the retail level, prices of essential goods have shot up. In Delhi, for instance, rice has shot up by 21.5%, wheat by 8.3%, toor dal by 16.6%, gram by 18.7%, mustard oil by 30.3%, groundnut oil by 22%, vanaspati by 32.2% though sugar prices have remained constant. The latest consumer price index (CPI) at 5.7% for February 2008 is less than the wholesale price index (WPI) at 7.4% but that could well be because of the lag in the data. The WPI is also somewhat inaccurate because the base year (1993-94) is out-dated; the weights are also somewhat skewed—too much weight is given to manufactured articles, for instance.

Apart from the reasons given by Dr. Narayanan, poor procurement, depleted buffer stocks, increase in diesel and petrol prices, poor supply situation in pulses, edible oils, rise in global price of wheat by 90%, rice by 15%, steel and metal prices have contributed to rising prices. This combination of domestic and international factors is what makes the situation so precarious. The growth in money supply has also been much above the RBI's target for the year partly because the RBI is also trying to maintain the exchange rate in the range of Rs 40 to the dollar. The net result of all this is high inflation.

So what are the policy options for the government? Import duties can be reduced, supply must be augmented, distribution, especially through PDS, improved. Raising interest rates could be an option; so

also price control on essential commodities and rupee appreciation. Inflation implies redistribution from poor to the rich, lower industrial growth, loss of export competitiveness and of course, there is huge political fallout that no democratic government will be happy to countenance.

Dr Abhijit Sen, Member Planning Commission, pointed out the reason for the poor quality of data was because "we get data from only a very small number of manufacturing companies and it is often late". Steel prices, for instance, increased in January but could not be incorporated in the WPI till March. "The sudden pick up in the WPI in recent past suggests we may see a similar pick up in the CPI too – today we do not see that because we have CPI data only till February," he said.

On Dr Narayan's second poser he was of the view that commodity numbers were already impacting inflation and have been doing so for a while now. On the issue of why this was not foreseen while framing the Budget, he reserved his comment. Prof. Sen pointed out that the price of rice rose much more dramatically than that of wheat and the main reason for this was that rice was exported. Indian exporters have exported about five million tonnes of rice this year till the government imposed restrictions. ``So in the case of rice it is not that

we are importing inflation; our exporters are merely reacting to higher prices abroad," he said.

Vegetables prices, he argued, have been much more erratic and are possibly the result of the sudden rise in temperature in February. He believed the situation would get back to normal pretty soon.

To the question whether we should view inflation purely from the supply side or from the demand side as well, he said the answer was a bit complicated. Money supply growth rates were higher than warranted but that had been so for a while now. On the supply side the worry is that prices were lower than world prices for most commodities so there was a huge arbitrage opportunity that in turn was driving up prices.

On the issue of whether small and marginal farming were becoming unviable, he argued that knee-jerk reactions could create a situation in which by trying to save the consumer, we end up hitting the farmer as in the case of the reduction in customs duty on edible oil imports. During the past few years, farmers have suffered a double whammy. They got very little growth in their output and they got very little increase in prices. This is the period during which the so-called agrarian crisis built up. Any solution to this must involve a certain increase in prices.

Taking up the discussion Dr B.B. Bhattacharya, Vice Chancellor, Jawaharlal Nehru University, endorsed the point made by Dr Abhijit Sen about the poor quality of data due to non-receipt of information. He also pointed out another flaw with the WPI-- it does not reflect the changed structure of the Indian economy. This was equally true of the CPI as well, he added. The current price rise, to his mind, was not at all unexpected. It was very much in line with historical trends and global factors. Depleting food stocks in countries like India combined with rising incomes in emerging countries presaged a rise in demand globally. Unfortunately, this coincided with energy prices also rising resulting in diversion of agricultural area to production of bio-fuels, disturbing the global food demand-supply balance. With globalization, it was but natural that prices in India would move in line with international prices, he argued. The right moment for policy makers to intervene would have been sometime in November/December but because the underlying trend became obvious only much later, we were caught unawares, he said.

He was of the opinion that inflation would continue at this level or thereabouts for some more months or at least weeks "before we start seeing a decline". This time recession in the western countries or the spectre of recession, he said, had not dampened the international oil price because, unlike earlier, the current oil price rise was sustained by

the sharp increase in demand for oil in emerging economies. He saw no sign of that dipping.

Coming to solutions, Dr Bhattacharya did not agree that growth in money supply was a factor. The only justification for a reduction in money supply would be if the intent was to dampen inflation expectations. He suggested utilising part of the country's forex reserves to buy some essential commodities even at a higher price, if necessary, and sell it at subsidized prices. The government budget will have to find a way to bear the burden. If domestic farmers are subsidized through a procurement price hike and urban consumers are protected by importing and selling at a subsidized price then as long as the monsoon is normal this year (early predictions suggest that will be the case) we should soon find the situation returning to normal and inflation trending down to settle around its core level. But if it does not then we may again have to re-focus our energies on more proactive steps. He argued that monetary policy acted with a fairly short time lag - 50-60% impact is felt within five-six weeks, according to his estimates - though the full impact may take about six months and hence it should be tried.

Speaking next, Dr Arjun Sengupta, member Rajya Sabha, argued that if the present rate of growth were to be maintained "then perhaps we should not do anything about inflation because a level of 7 - 8 % is

not very high by historic trends". Secondly, it is widely accepted that moderate inflation, if it is stable, may not really affect economic growth. We need to worry only when the rate of inflation rises so high that it generates inflationary expectations because such expectations can damage investment sentiment and hurt growth. The main question, to his mind, was whether we have reached that stage. He said we have not.

He argued that if growth was the main consideration and the welfare effect was regarded as less important, then possibly there is no case to do anything that might harm growth. Knee-jerk measures to contain inflation such as the ban on export of non-basmati rice, for instance, could hurt producers much more without benefiting consumers. Citing empirical evidence that going against the market was not been very successful, he pointed out that it was important not to go against the market as far as possible. Raising interest rates, for instance, could damage growth.

With international prices higher than domestic prices, domestic prices are likely to rise further. In such a scenario raising interest rates could prove counter productive. It could also lead to further Foreign Institutional Investor (FII) inflows that, in turn, would result in additional liquidity if the Reserve Bank of India intervenes to prevent the rupee from appreciating. He said there was no need for the

government to panic. This year the monsoon was expected to be normal and ``we should soon see prices coming down``. He said welfare effects were a matter of concern and it was true inflation hit the poor hardest but in the ultimate analysis it was a question of government's priorities.

Importing food grains could help ease the supply crunch but given that global prices were ruling very high, it would require substantial increase in food subsidies and deficit financing. This has grave implications for the government as it will play havoc with the Fiscal Responsibility and Budget Management Act targets. Hence he was inclined to think that there would be no substantive change in government policies.

Dr Jagdish Shettigar of Bharatiya Janata Party argued that rather than the level of inflation *per se* it was the nature of inflation that was causing concern. He said the problem began almost two years ago but the government failed to take timely corrective steps. To his mind there was clear evidence of procurement failure resulting in inadequate buffer stock. The FCI was not able to procure the full quantity needed to keep the buffer stock at the required level during the last year but the government did not try to fix the problem. He said the government should examine why its agencies failed to procure adequate food grain stock even as the private sector managed

to so without any problem. He called for a serious re-look at the minimum support price system.

Alternatively, procurement could be left to the private sector with the caveat that they have to contribute to the buffer stock. He disagreed with the view that higher petroleum prices were a factor on the grounds that government had revised the prices only once during the past two years. He said a tighter monetary policy would have reined in the inflationary trend which was driven by excessive demand. However, he said, today inflation was almost entirely a supply side problem. Lambasting the government for going back to administrative controls, he argued that government should take immediate steps to build up a buffer stock.

Professor Gurcharan Singh of JNU pointed to the dangers of focusing excessively on the short-term to the exclusion of longer-term issues. "Unless we pay heed to the latter we run the risk of history repeating itself a few years down the line," he said. Saying it administrative reforms were overdue, he urged a re-look at delivery mechanisms especially in the context of the PDS. He said if the poor were to be protected from inflationary trends, there was an urgent need for a functioning delivery system, viz a good public distribution system.

The problem goes beyond the immediate food crisis, he said. The low tax-GDP ratio meant government had limited resources at its disposal to import food grains, for instance. Nor was the problem limited to the rural poor. Urban poor and middle-income classes were also affected by rising prices and the government should think of ways and means to protect their real incomes from inflation.

Manish Tiwari of Congress-I put up a vigorous defence of the government's performance saying media was making much more noise than warranted. The price rise, in his opinion, was really limited to only a few items of consumption like edible oils. He hinted that in most cases the situation was aggravated by the inaction of state governments who failed to crack down on hoarders and black marketers. In the case of steel, the price rise was possibly on account of cartelization, he suggested.

Prasanjit Bose of the CPI(M) argued that interest rate hike and rupee appreciation were not a remedy to cost-push inflation. Criticising the government for its management of the food economy, he urged a revamp of the Minimum Support Price policy and strengthening of the procurement and delivery system. Subsidies, he argued, should not be considered a bad word and, if necessary, government must be prepared to spend more money on subsidies.

As far as inflation expectations were concerned, he was critical of the role of commodity futures markets and said "they aggravate price rises whenever there are shortages". He defended the government's decision not to hike fuel prices in response to global oil price hikes and argued that the right approach would be to reduce customs duty on oil products. A specific duty on oil would ensure that the people, rather than the government exchequer, gained when oil prices shot up. It would also give some relief to retail consumers, he said.

Reiterating his party line, he argued that today globalisation was responsible for importing inflation ``but tomorrow, if we continue down the same path, with the US in a recession we could well end up importing unemployment as well``. With the world heading towards a repeat of the stagflation (slow growth combined with rising inflation) witnessed in the 1970s, the Indian economy had to be insulated rather than get more globalized, he added

Disagreeing with the previous speaker, Mythili Bhusnurmath, Consulting Editor, Economic Times, came out strongly in favour of allowing market forces to function. She said in a country as poor as India there would always be a large number of people priced out of the market and the State was bound to take care of them. She was critical of the low priority attached to improving the quality of the data. She said it was wrong to presume that higher oil prices had not

affected the price levels. The impact of oil prices was felt through a higher fiscal deficit, explicit or implicit and higher borrowing by oil companies.

In the short-term, the government does not have too many options given that inflation was presently a global phenomenon and essentially supply-driven. Measures like reducing import duties on some commodities like edible oil and certain kinds of steel go a certain way in defusing the crisis but some of these measures, such as the ban on export of some commodities, could do long-term damage as they destroy the credibility of exporters in world markets. She agreed with earlier speakers on the need for strengthening the PDS, especially for those below the poverty line (BPL). In short-term, the buffer stock must be built up, if necessary through imports, she argued.

As for long-term, the only solution was reforms in the agriculture sector on the lines of what was done for industry in 1991, she argued. The farmers have to be enabled and empowered to respond to market signals and the huge distortions, both the input as well as output side, removed to infuse the kind of vitality that fuelled the industrial growth in India. At the same time, the government must make amends for its long-term neglect of agriculture and increase public investment in the sector. It must fix the agriculture extension

service that played such a vital role during the first Green Revolution and create the conditions necessary for a second Green Revolution in the country. Productivity levels in Indian agriculture were way below the levels in other countries and there was no reason why India cannot be self-sufficient if productivity levels were raised, she argued.

Atul Anjan of the CPI was as critical of the government as his CPI (M) comrade. He emphasised the need for beefing up the PDS and the folly of neglecting agriculture. He said ``inflation has not helped the farmer due to the bottlenecks in managing our food grains with distress sale seen in some parts of the country coupled with soaring prices in other parts``.

In the discussion that followed, many speakers pointed to the poor state of the PDS; one speaker alleged that between 2000 and 2004 the diversion of foodgrains from UP to Nepal and Bangladesh was to the tune of Rs 438 crores and estimated that figure for the entire country might be closer to Rs 60,000 -70,000 crores. The greater success of private procurement over government procurement, it was argued, was not because private trade paid farmers more than the MSP but because the farmers were freed from paying the Mandi fee (the fee to the local market or *mandi*).

The merits of allowing the private sector to get into areas like food procurement was hotly debated with the speakers from the Left parties arguing the private sector had no role in sectors that were concerned with the basic necessities of life such as food and education. This view was disputed by others on the grounds it would be more efficient to let the private and the public sectors to co-exist, with the private sector catering to those who were able to pay and the public sector (read government) using taxpayer money to take care of those who were priced out of the market.

It was also pointed out that maintaining a buffer stock cost money; during good years when supply was more than demand there was a huge carrying cost and the government could end up selling the amount procured in excess of needs at below the procurement price, as happened during the NDA years.

There was broad agreement on the need to improve farm productivity and to provide the farm-to-market link whether by way of roads or warehouses and cold storages to prevent food stocks from rotting.

Intervening in the discussion, Dr Abhijit Sen argued that the present price situation was abnormal. He was firmly of the belief that they were not linked to supply shortages as world over it had been a good

year for agriculture. He cited high speculation in commodities as an important factor in the high inflationary trends.

Rounding up the discussion, Dr Narayan summed up the following main points that had emerged.

1. **Strengthen the public distribution system**: Two suggested options were—a. release the stocks and hope that the procurement would be good and an immediate increase in the support price combined with concerted efforts to ensure as much as possible gets into government godowns, etc; b. To import at whatever prices, but make sure that it is sold through the PDS with the subsidy being borne by the government budget.

2. **Government share in private food import**: Giving the example of Singapore, where the government mandates that a certain percentage of all food imports by private trade must be given to government at government-notified prices, he argued this could be an alternative that could be considered in India.

3. **Increase agriculture production**: Conceding that there was a need to increase productivity in agriculture, Dr Narayanan pointed out it was a long-term goal and it would not be of any

help to tackle the present crisis. He was all praise for what Bangladesh has done in the last 4-5 months. Despite a serious flood in October-November 2007 the country is likely to have a bumper crop now thanks to extensive government intervention to ensure adequate supply of fertilizers, seeds, pesticides and so on. There is constant monitoring at the district level and detailed information is available on the internet, something we ought to emulate as well if we are serious about our agriculture sector, he said.

*__Abhijit Sen (Member, Planning Commission), Arjun Sengupta (MP, Rajya Sabha), B.B.Bhattacharya (JNU, Vice Chancellor), Gurbachan Singh (Professor. JNU), Jagdish Shettigar (BJP), Prasenjit Bose (CPI-M), Manish Tiwari (Congress), Atul Anjan (CPI), Mythili Bhusnumath (Consulting Editor, Economic Times)__