

Underlying Causes of India's Inflation

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Inflation has raged unabated in India for the past five years, bringing us back to the drawing board for its underlying causes? The economic establishment remains clueless as to its underlying causes. I hope this gathering of the sharpest minds will bring more clarity to this issue.

India's growth has declined in the last two years but so has growth in most emerging markets. The decline in India's GDP growth has been bigger since 2010-11 - by about 4 percentage points - whereas the average for emerging market economies is a decline of GDP growth of around 2 percentage points. So about half of the decline in our GDP growth rate can be explained by the same global factors that have affected all emerging market economies but in our case we have seen a further GDP growth decline of 2 percentage points which can be attributed to domestic factors

But inflation remains a puzzle because India's inflation rate has remained high while declining in the advanced economies and in emerging economies over the last 5 years. What is surprising is not just the level but the persistence of inflation, with no clear consensus on its underlying causes. In the past when India was a closed economy, India's inflation was higher than world inflation when the shocks to the economy were largely domestic - often in the form of a drought- and on average lower than world inflation when shocks were external such as the oil price shock of the 1970's. But today with a largely open economy and a mostly open capital account it is hard to understand the persistence of high inflation in India over the last 5 years when the world has been worried about deflation not inflation.

There are three broad explanations on offer to explain high and persistent inflation since 2009.

The first explanation is that India recovered quickly from the global crisis with large fiscal and monetary stimuli. But these stimuli were maintained for too long and helped fuel inflation. Interest rates were allowed to remain low for too long and with a mostly open capital account FII increased sharply, the real exchange rate appreciated sharply, and the current account deficit widened to dangerous levels. A consumption boom followed and wages and land and services prices (non tradable) went up sharply. The RBI started tightening monetary policy in late 2011 but it came too little and too late. By this time the economy was also slowing down and so aggressive monetary tightening had to be tempered to avoid hurting the economy further. But with inflationary expectations having set in core inflation rose and now more aggressive monetary tightening and inflation targeting will be needed to break inflationary expectations.

While monetary tightening began in 2011- loose fiscal policy continued unabated. Moreover the composition of government expenditure shifted heavily from public investment which would help crowd in private investment to public consumption through a sharp increase in subsidies- especially on fuel, and wage payments. Rural programs such as MGNREGA also brought more money into the hands of the rural poor and rural real wages increased. With more income in the hands of the poor, whose marginal propensity to consume food is high,

demand for food increased and food prices rose. With rising food prices, wages also rose and a wage - food price spiral fueled inflation further. As incomes of the non poor rose their consumption basket shifted from grains (calories) to proteins (pulses, egg, meat), oil seeds and vegetables, whose prices rose sharply leading to high inflation. With government expenditure remaining high and with the prospect of a further increase in wages by announcing a new pay commission the expectation of a wage - price spiral has now been cast into the expectations. Linked to this is the argument that India's potential growth is now down to 5 percent and will need to be raised by reviving public and private investment if India wants to grow at above 8 percent with low inflation.

The third is the transmission of international real food price increases. Real food prices - measured by the FAO food price index deflated by the unit value index of manufacturing have increased permanently as land shifted from food grain to biofuel production. This shift in the real price of food was transmitted into India slowly over a 4 year period by increases in the minimum support price until it has now caught up with the international price for food gains. As grain prices were increased grain production went up but the FCI purchased the grain and increased grain stocks to record levels - which reduced grain supplies and increased grain market prices sharply fueling inflation.

With the catch up now complete future MSP increases will be moderated and will help temper domestic inflation. This explanation of higher inflation seems plausible for food grains prices but still cannot explain the rapid inflation in other food items - vegetables, eggs, meat, milk, pulses and oil seeds. For these commodities the issue remains as to why their supply elasticity to higher prices is low. One explanation is that with higher MSP for food grains and huge FCI stockpiles which keeps market prices high, the production of food grains remains profitable and reduces the incentive to shift to riskier vegetables and other more profitable commodities. A second explanation is that it's not easy to increase the supply of these commodities in the short run as fixed costs of shifting are high. A third explanation is that without better retail chains the higher prices are mostly captured by intermediaries and do not reach the farmer - especially as the APMC act discourages competition in distribution systems.

With the persistence of high inflation all three factors - monetary, fiscal and administered price policy are now in the mix and it's hard to disentangle their effects. The expectations that once MSP price increases were moderated it would quickly lower inflation are now unlikely with core CPI inflation stuck above 8 percent. With payments in the budget such as interest payments, wages and many programs such as MGNREGA now indexed to inflation controlling public consumption will not be easy. The fiscal cuts have largely come by slashing public investment which then crowds out private investment and hurts growth. Attempting to break inflationary expectations will now require prohibitively high interest rates which will increase the governments own interest bill and hurt growth further.

Any new government will need to take a comprehensive look at a package of measures that will reduce inflation and revive growth. It cannot be tackled by any single instrument with only inflation control as the primary objective. The interactions between monetary, fiscal and price policies will need to be taken into consideration in a comprehensive package to get out of our current staglatory predicament.