

The Third Shri R.Venkataraman Endowment Lecture

**"RECENT BOUTS OF INFLATION IN INDIA: POLICYPARALYSIS?"**

By

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Madras School of Economics

## Recent Bouts of Inflation in India: Policy Paralysis?

T.N. Srinivasan

### Part I

1. It is a great privilege and an honour for me to be invited to deliver the third Shri R. Venkataraman Endowment Lecture. I thank Dr. D. K. Srivastava, Director and Professor U. Sankar of the Madras School of Economics (MSE) for the invitation. I have fond memories of the founder of MSE, the inimitable Raja Chelliah. He left a legacy to the nation of two outstanding institutions, the National Institute of Public Finance and Policy at New Delhi in the North and the MSE at the dynamic capital, Chennai, of the fast growing state of Tamil Nadu in the South. Chelliah aptly captured a well known description probably from Vishnu Purana among many of boundaries of Bharata Varsha as “Aasetu Himavat Paryantam” from South to North on “Himavat Setu Paryantam” from North to South in his institution building.

2. President Venkataraman (hereafter RV as he was widely known) was an economist and a lawyer. He served the nation with great distinction in many capacities, as a Member of Parliament and Tamil Nadu State legislature, as a trade union leader, Minister of Industries and Labour in Tamil Nadu and Union Minister of Finance in the Indian Gandhi Cabinet after the 1980 election. His achievements were many and well known. In his second lecture of this series in March this year, Vijay Kelkar spoke of his critical role as President during the turbulent times of 1987-1992. The nation experienced political instability with three Prime Ministers during December 1989 and June 1991, a severe macro-economic and balance of payments crisis in 1991 that brought the nation near default on its external debt, downgrading of its credit rating,

and above all the humiliation of having to pledge the nation's gold stock abroad for short term credit. The period also saw the initiation of hesitant and piecemeal economic reform and liberalization in the mid 1980s and systemic and broad ranging reforms in 1991. In many ways, RV's last two years as President saw a transition of the Indian economy from an insular inward oriented one to an increasingly globally integrated one in trade in goods services as well as finance. Let me join in Kelkar in saluting RV for having played a crucial role of support during this critical period as well as his manifold achievements.

3. My topic Today is the recent bouts of inflation. India now has the dubious distinction of having by far the highest rate of inflation of 7.5 percent among the world's largest economies in 2010. Naturally I turned to RV's thoughts on speeches presenting the budgets of 1980-81 and 1981-82 as Finance Minister, since he then faced the spectre of rising inflation and international economic environments similar, though not identical, to what we face today. Of course then, the monetary policy of the Reserve Bank of India (RBI) was totally subservient to the dictates of the Ministry of Finance and the non-public sector commercial banks were far less relevant for credit disbursement and selective credit controls were ubiquitous. Above all the shift away from the capital-intensive heavy-industry oriented industrialization and import substitution as the development strategy implemented by the infamous Licence-Permit-Raj was yet to happen. One of the ostensible justifications for the nationalization of commercial of banks in 1969 was a form of the current mantra of, "financial inclusion". Allowing for these differences, RV's clear understanding of the policy tasks, both monetary and fiscal is not only remarkable but also continued to be relevant now.

4. In his speech on the 1980-81 (final) budget, RV noted the serious deficiencies in the performance of the infrastructural sectors of coal, railways and particularly in power

with planned and unplanned outages and a low capacity utilization of 45 percent of thermal capacity. These along with a drought in 1979-80 led to significant drop in aggregate supply and an inflation of 20 percent. He went on to say “In the light of the problems currently facing the economy the tasks to be accomplished are clear enough. As there is a great deal of inflationary potential in the economy, the prime objective of our policy will be to achieve price stability. This will have to be done through an increase in aggregate supply and a moderation of aggregate demand. Therefore, we intend to continue our efforts to improve the working of the infrastructure and to augment available facilities with investment wherever necessary ... With regard to demand management, we shall have to pursue a policy of linking bank credit expansion to productive and priority purposes and check the diversion of funds to speculative ends. We will also have to pursue an interest rate policy which will help in the abatement of inflationary pressures without hurting productive activity ... Since there is a great deal of liquidity in the system, there is an obvious need to minimize the growth of money supply by keeping the budget deficit at a much lower level than in 1979-80. This will require a fiscal policy which will reduce wasteful and unnecessary expenditure, invest resources in increasing the economy’s production potential and maximize the revenue potential of the existing tax system”. Three decades after RV’s speech it is sad that the issues of poor infrastructure performance, high fiscal deficits and incipient inflationary pressures are still with us. I will argue later on that his implicit recognition of the need for coordination of fiscal and monetary policy tasks no longer seems to exist.

5. In presenting the next year’s budget in 1981-82 RV noted the improvement in the inflationary situation and understandably took credit for it. But he was by no means complacent. He said “I must caution however that although inflation has abated, it has not been overcome. The economy remains subject to continuing cost push pressures, including especially the transmission of international inflation through rising prices of oil

and other essential imports ... It is essential to evolve a strategy for coping with cost-push inflation effectively by tackling – the problem at its roots. This is not only a matter of demand management. It also requires an all out effort to increase efficiency and achieve higher productivity”. With the easing of the crisis situation of the previous year he argued, “The emphasis in 1981-82 must therefore shift from crisis management to growth ... But it must do so in the full knowledge that the threat of inflation has not been fully overcome. The fiscal deficit should therefore be kept within tolerable limits”. I will come back later on to the growth slow down since the last quarter of 2009-10. It possibly reflects increases in repo rates by RBI alone with no apparent action by fiscal authorities.

6. Interestingly he highlighted a problem that also persists even now but that is not often discussed, namely, the stagnation of the share of financial savings a sequence of the largest saver accounting for 70 percent of domestic savings of the economy, namely, the household sector, at around 11 percent of GDP or about a third of the total gross domestic savings rate of around 34 percent of GDP in 2010. He put it in slightly different terms, “Along with fiscal discipline we must also take steps to encourage the flow of private savings into the financial system ... This flow of resources into the financial system is threatened in two ways and we must tackle both. First of all, it is threatened by the pernicious growth of the black economy. A second impediment to financial savings is the existence of high rates of inflation”. Again black money stashed away in secret accounts abroad and inflation are with us now.

7. I will note later on that our current Finance Minister Pranab Mukherjee in his recent suo motu statement in the Parliament on November 27, 2011 on inflation and a durable solution for it, in essence re-emphasized RV’s diagnoses of the malady of inflation as well as cures for it both preventive and curative.

8. We all owe a deep debt of gratitude for the clarity and foresightedness of his vision for our diverse economy, its plural society, and its democratic polity and for his quiet but firm guidance during a very turbulent period.

## **Part II**

### **Measurement of Inflation**

9. Containing Inflation, defined somewhat loosely as a sustained increase in overall prices over an extended period of time is a concern of policy makers including central banks of most countries of the world including India. In this lecture I will explore several aspects of inflation in India, particularly the analytics of the inflation process; trends in price changes since 2004-05 till November 2011. Monetary policy tools are the primary, though not the only, policy instruments for dealing with inflation. Central Banks are charged in many countries with maintaining price stability as one of the macroeconomic objectives of monetary policy in combination with other objectives, such as sustaining full employment or ensuring that the aggregate economy operates at or close to its potential. Implicit in these objectives is to contain the adverse consequences of sustained inflation, less than full employment, and the operation of the economy below its potential on consumer welfare. RBI's ultimate objective is sustained growth with financial stability. From a consumer welfare perspective, the relevant price index is the consumer price index (CPI). On the other hand, broadly speaking, prices received by producers at the farm or factory gate influence their incentives for production and hiring. As such, a Producer Price Index (PPI) is also used in policy discussion in many countries in conjunction with an aggregate CPI. Neither an aggregate CPI (until very recently) nor a PPI are compiled and published in India.

10. Inflation is measured in India by the rate of increase in any period (week, month or year) over its value in the corresponding period of the year before of the Wholesale Price Index (WPI). This year-on-year or y-o-y rate of increase is called Headline Inflation. In addition policy makers and particularly the media document the trend in one particular component of WPI, namely, the index of Wholesale Prices of Food Articles. To call it “Food Inflation” is misleading since doing so does not distinguish between a rise in price of food articles at the same rate as the rise in overall prices and at a rate different from it. The former implies no change in the prices of food articles relative to the basket of all commodities.

11. The inappropriateness of using WPI for measuring inflation has long been recognized by policy makers including former governor Y. Venugopal Reddy and the current governor Subbarao. Yet according to the latter the RBI has opted for WPI over Consumer Price Index (CPI) for a number of reasons, one of which being that until February 2010 an All India CPI for consumers was not available. Another reason of WPI’s alleged clarity in communicating RBI’s policy stance. Neither reason is particularly convincing. Moreover the Indian WPI, is neither a producer, nor even strictly speaking, a Wholesale Price Index, since it uses retail price quotations for some and wholesale prices for other commodities. It does not include services. Unlike the almost universal practice of publishing seasonally adjusted prices indices, no such series of WPI or CPIs are published in India. Although each of the four available CPIs, covers a different subgroup of the population, they include services. It is also the case that trends in the four CPIs in WPI often differ. Still, there is no reason for not using them altogether. After all with the economic knowledge and statistical power in RBI, some sensible statistical adjustments could have been made to take into account their deficiencies and so adjusted aggregate CPI could have been used. In any case, it is to be hoped that once

enough data with the new CPI accumulate, the RBI will switch to its use for monetary policy formulation.

12. I have proposed elsewhere that in addition to the new CPI, a new appropriately defined producer price index as well as a cost of living index should be compiled and published. In India there are no systematic procedures for incorporation of new goods and quality improvements in old goods in the price indices. Although such procedures exist in US, they have been found by the Boskin Commission to be inadequate and may have resulted in the overstatement of CPI inflation. Introduction of systematic procedures for reflecting quality improvements and the availability of new goods in price indices in India is urgent, given the strong theoretical presumption and empirical evidence that with trade liberalization and greater competition, the pace and quality of improvements and widening range of goods available in the market has been accelerating. Since these changes took place over a period of time and their full impact may take even more time to be realized there is a strong presumption that the Inflation rates in India are overstating their true values although the extent of overstatement cannot be ascertained without a careful empirical study.

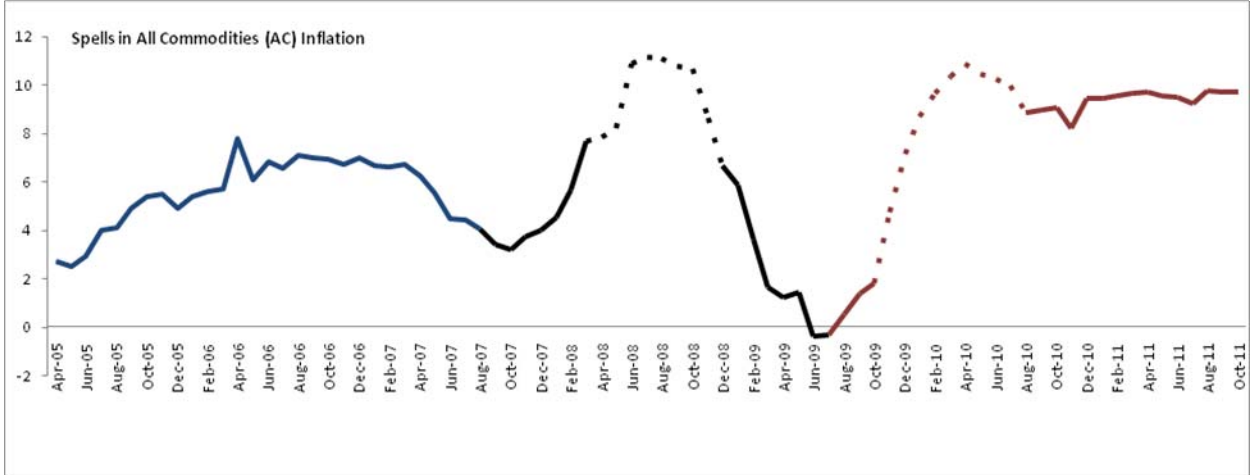
### **Trends in Inflation: Headline Inflation**

13. The trends in the monthly Year on Year rates of change in WPI for all commodities from April 2005 to October 2011 and weekly price trends for some important items till November 26, 2011 are available. Obviously one could define other rates in a similar fashion---for example, the annualized percentage rate of change of the current week's index over its value in the previous week is a very short-term week on previous week inflation rate. It is easy to see that these rates, being all based on the same data necessarily imply a purely arithmetical inter-relations among each other.

14. The weekly inflation rates are likely to be more volatile than monthly and annual rates. The trends in monthly rates suggest that in the 79 month period from April 2005 to October 2011, the most recent spell of sustained inflation for all commodities seem to have begun in August 2009. In 23 months from December 2009 on, monthly rates of inflation exceeded 7 percent, and in 18 of them, 9 percent. In fact, this spell itself was preceded by another of 30 months from April 2005 to September 2007. Taking the two spells together in the 79 months between April 2005 and October 2011 inflation rates were 7 percent or higher in as many as 44 months.

15. These spells are shown in a temporal sequence in different colours in Figure 1, and each component of this sequence of spells is charted in Figure 2A, 2B, and 2C, respectively. The rising and declining phases of each spell are also illustrated. Clearly the seeming persistence of inflation near 7 percent or higher a year over such a long period calls for an analysis in depth of its determinants that goes beyond ad hoc explanations.

Figure 1: Spells in All Commodities Inflation



**Legend:**  
 First Spell: April 2005 – September 2007 ————  
 Second Spell: October 2007 – July 2009 ————  
 Third Spell: August 2009 – October 2011 ————  
 Basu's spell: March – December 2008; December 2009 – April 2010 .....

Figure 2A: Spells of Inflation All Commodities (AC) Disaggregated – Spell 1

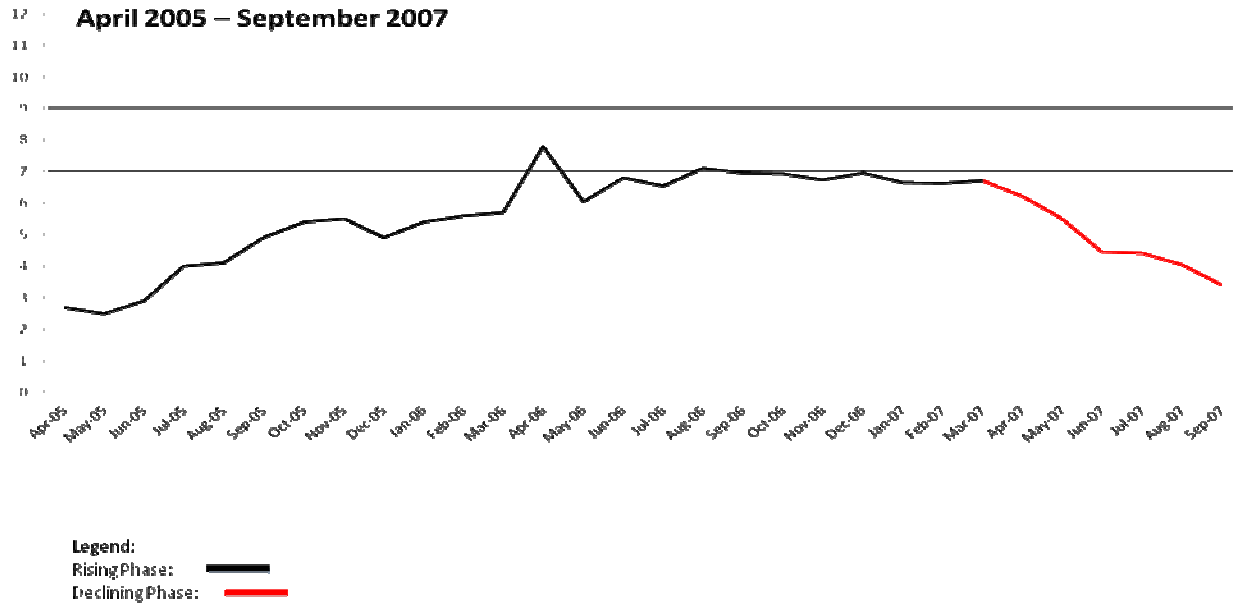


Figure 2B: Spells of Inflation All Commodities (AC) Disaggregated – Spell 2

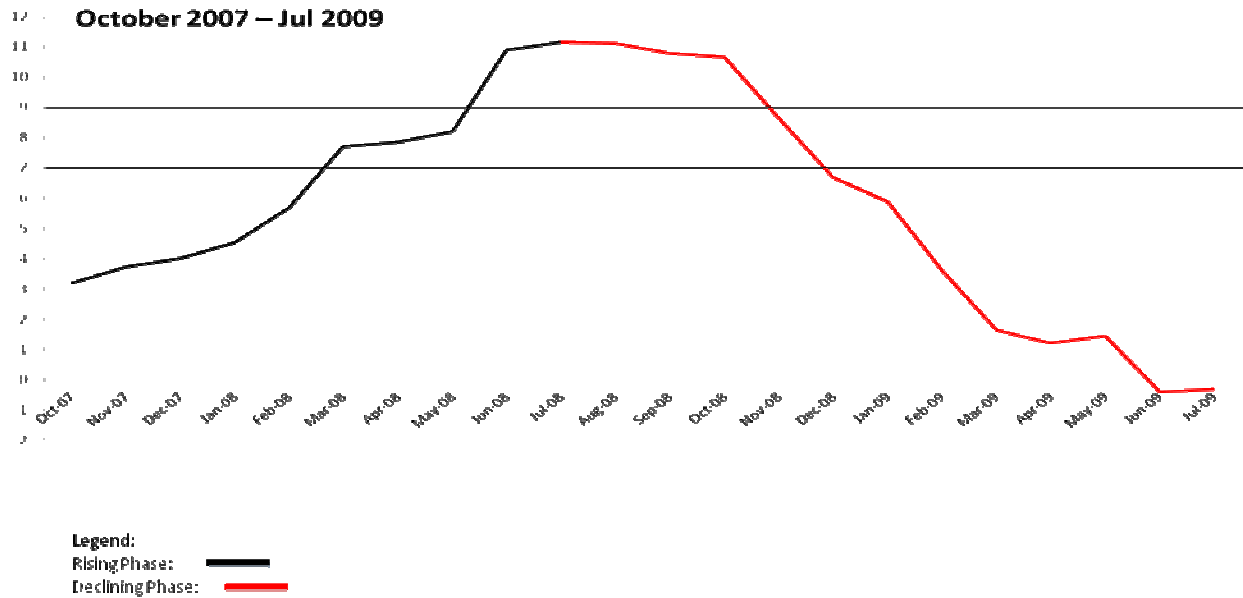
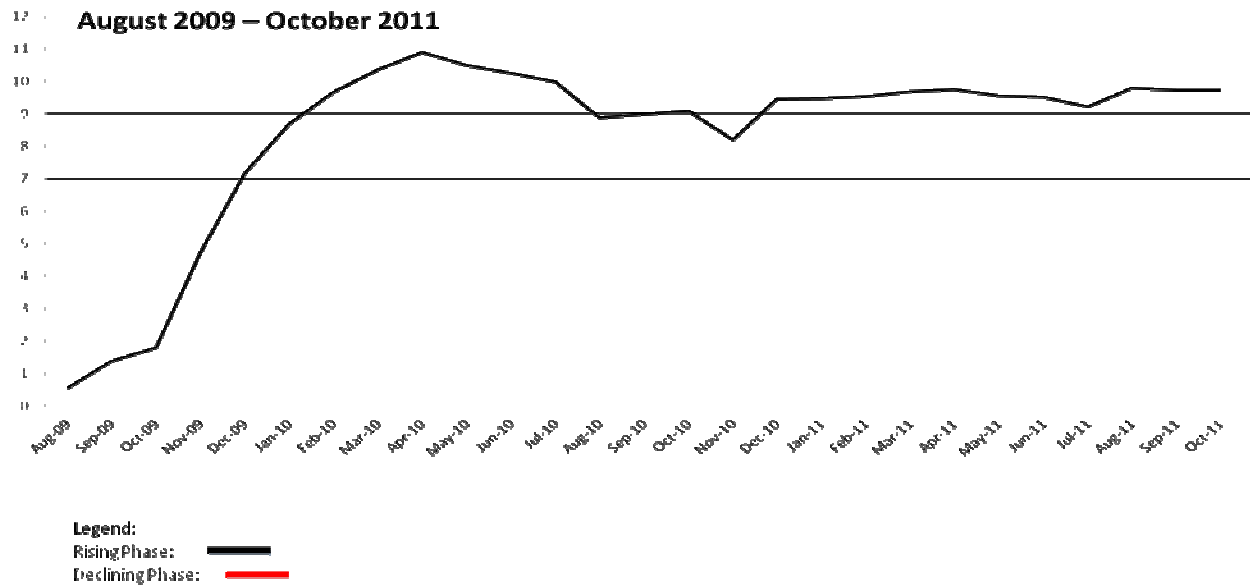


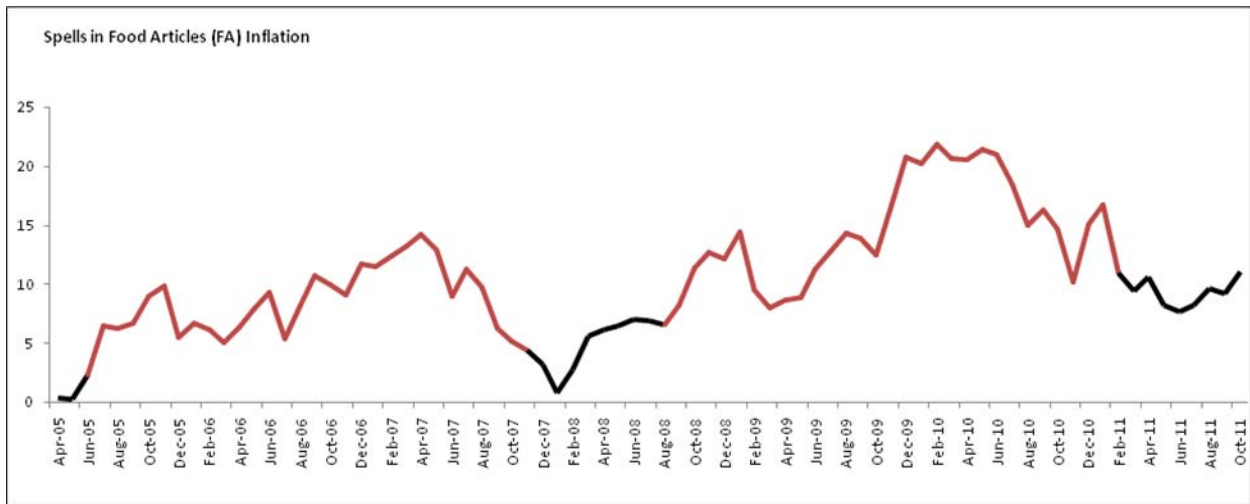
Figure 2C: Spells of Inflation All Commodities (AC) Disaggregated – Spell 3



### Trends Inflation: Food Inflation

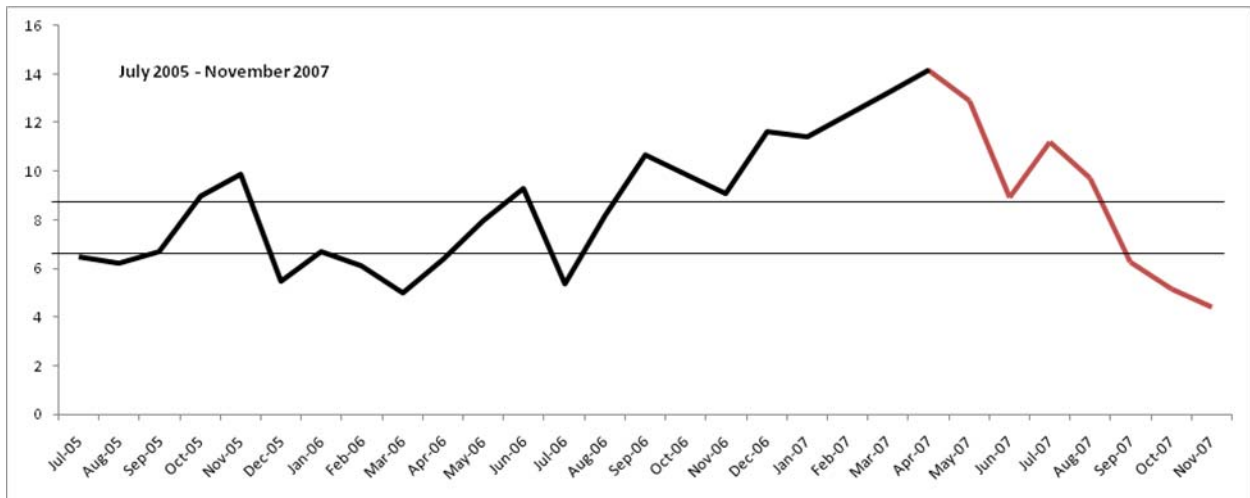
16. The time pattern of changes in the price of food articles is not the same as that of all commodities. In the period of 79 months since April 2005, nominal food prices rose faster in 55 months than the nominal value of the bundle of all commodities. However, 53 of the 55 observations were in just 2 long spells, with 26 of them in the 29 month period from July 2005 to November 2007, and another 27 in the 29 month period from October 2008 to February 2011. The two spells in inflation of Food Articles Prices are shown in temporal sequence in Figure 3 in different colours. Each component of this sequence of spells is charted in Figure 4A and 4B respectively. The rising and declining phases of each spell are also illustrated.

Figure 3: Spells in Food Articles Inflation



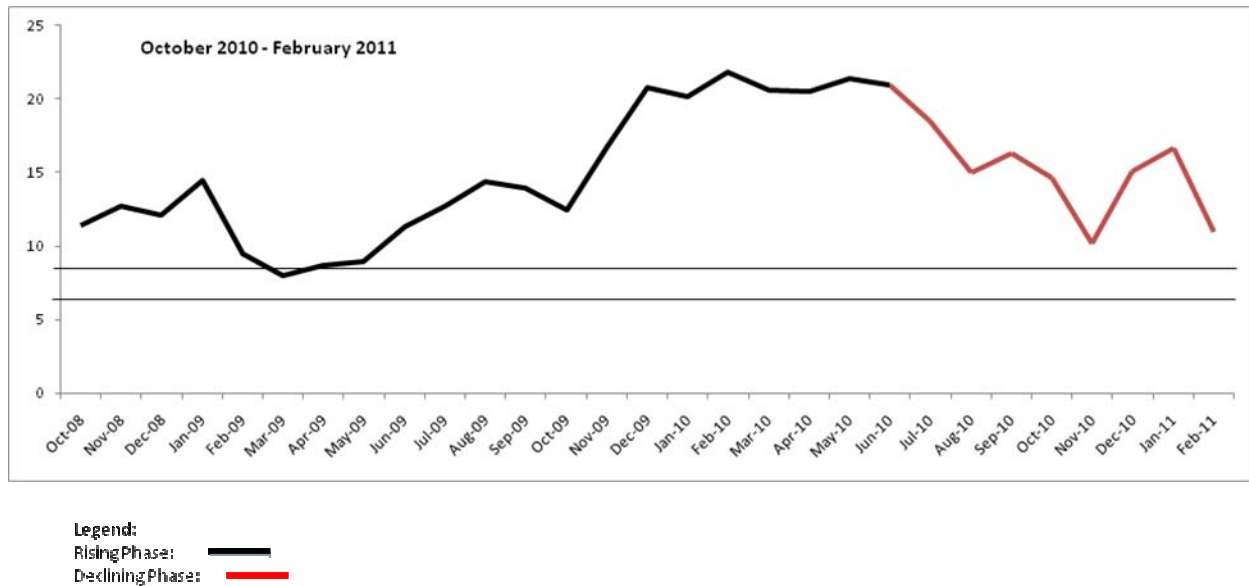
**Legend:**  
 First Spell: July 2005 – November 2007  
 Second Spell: October 2008 – February 2011

Figure 4A: Spells of Inflation Food Articles (FA) Disaggregated: Spell 1



**Legend:**  
 Rising Phase:  
 Declining Phase:

Figure 4B: Spells of Inflation Food Articles (FA) Disaggregated: Spell 2



a

17. Clearly the relative price of food articles has been rising for most of the period since April 2005. In 34 months, inflation in all commodities during this period was 7 percent or higher and higher than 9 percent in 23 of them. Inflation in food articles however was at or higher than 7 percent in as many as 55 months and above 9 percent in 44 of them.

### Repo Rates and Inflation

18. Figure 5A and 5B highlight the repo rates of the RBI during the spells of inflation in all commodities and food articles, respectively. The rising (declining) phase of inflation in all three spells in **all commodities**, loosely speaking, correspond with increases (decreases) in the repo rate, though an association between a rise (fall) in the repo rate and a subsequent decline (rise) in inflation rate cannot be clearly seen.

However a similar pattern is not seen in inflation in food articles. The rising phase of the second spell of inflation in food articles corresponds with a reduction in the repo rate.

Figure 5A: Repo Rates of RBI and Spells of Inflation in All Commodities

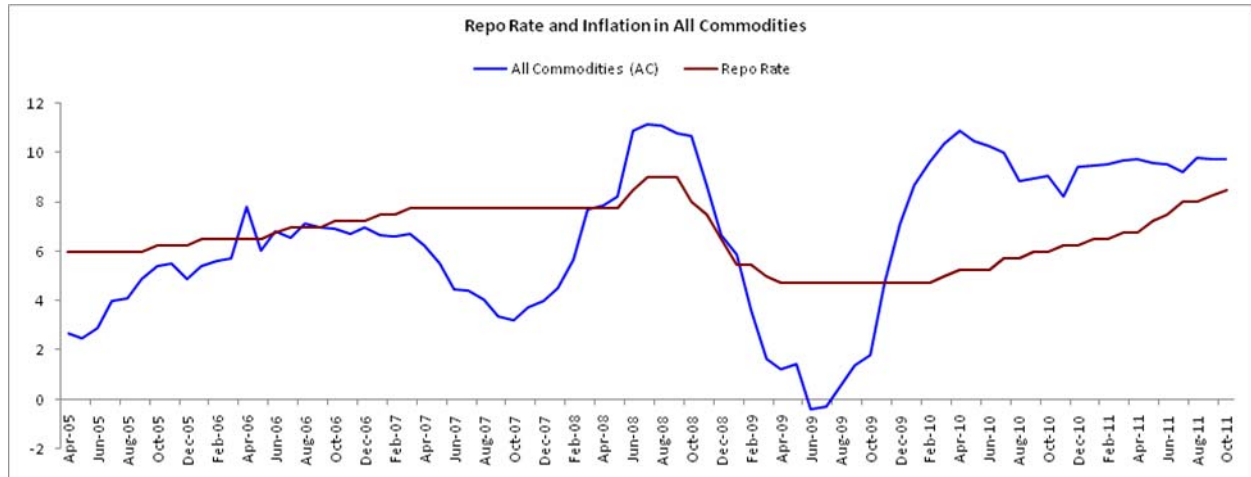
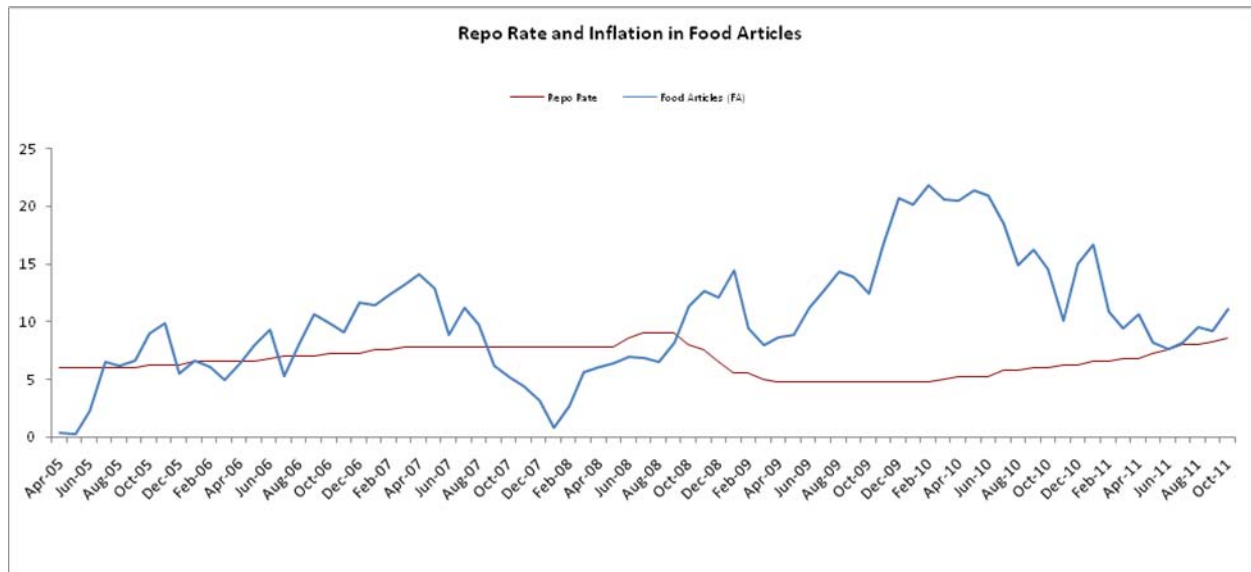


Figure 5B: Repo Rates of RBI and Spells of Inflation in Food Articles



19. A simple correlation between inflation in all commodities and repo rate yields a coefficient of 0.39, and coefficient of -0.47 between inflation in food articles and the repo rate. Although this is counter-intuitive, as is will understood the existence of a

statistically significant (positive or negative) correlation or lack thereof has no necessary implication for the existence of a causal relation and its direction between the two. But the analytics of inflation and the relation between inflation in food articles and all commodities are important issues.

### **The analytics of Inflation**

20. The importance of understanding the analytics of inflation for the purpose of formulating effective policies for tackling it cannot be overstated. First, Inflation being about changes in nominal prices over time, is a dynamic stochastic process requiring an inter-temporal framework incorporating the stochastic shocks to the economy for its analysis. Second, whether Milton Friedman's famous statement that "Inflation is always and everywhere a monetary phenomenon, in the sense that it can be produced only by a more rapid increase in the quantity of money than output" is a tautology or a deeper causal explanation, any analysis of inflation necessarily has to include consideration of monetary policy and financial sector behavior. Third, since the public as well as public policy concerns about inflation largely arise from its effects on the real sector, for analyzing them an integrated framework of the real and monetary sectors is essential. The real consequences are on consumer welfare, aggregate and sectoral outputs and growth, real investment, employment and so on. Clearly in a largely competitive market based private sector economy such as ours, decisions about what to produce, to consume, to export, import, on portfolio of investment in real and financial assets and their economy wide or aggregate consequences depend on the prices faced by those making the decisions at a point in time and overtime. Since some investment and in part production decisions will have their impact only in the future in the near and longer term, and the future prices are unknown and uncertain at the time current decisions are made, as Keynes argued long ago expectations of decision makers about future prices

matter. Thus the how expectations are formed is a crucial issue. Further private decisions are also influenced by public policies both macroeconomic and microeconomic and any anticipated changes in them. In particular distortions created by government interventions in markets could also distort private decisions depending on whether interventions are meant to correct market failure or otherwise.

21. Any satisfactory framework to be integrated framework has to incorporate real and financial sectors and variables in a behaviorally sound way. Ad hoc frameworks of integration is likely to be unsatisfactory in one or more ways.

22. The recent global financial crisis and the fact of its spread from the bursting of a real asset price (i.e. house price) bubble in the United States (U.S.) to the entire financial sector in the U.S. and then to the rest of the world was not foreseen by most analysts including academic economists. It also brought into sharp focus the inadequacies of macroeconomic and financial models. This has spawned a still growing literature on what is wrong with macroeconomics and macroeconomists. This is not the occasion to delve into this literature. Suffices it to say that there is yet no emerging consensus. Let me just say that the literature on India-specific empirical models of the dominant genre of Dynamic Stochastic General Equilibrium (DSGE) models are very few and even the genre as a whole and the India specific versions leave a lot to be desired.

### **Analytical Discussions of Indian Inflation**

23. There was a report in the Hindu of a brainstorming session on September 21, 2011 on inflation by the officials of the Planning Commission, DEA, RBI officials and academic experts of the IMF, World Bank, Asian Development Bank and others. The session was in fact a seminar organized by the National Institute of Public Finance and

Policy (NIPFP) in New Delhi. Apparently at the seminar Kaushik Basu, Chief Economic Adviser in the Department of Economic Affairs (DEA) in his remarks agreed with the comment of Govinda Rao, Director of NIPFP and a member of the Prime Minister's Economic Advisory Council in his introduction to the seminar that "the country's economic managers have not been able to fully grasp the processes underlying the persistence of high inflation."

24. Basu has recently published two avowedly analytical papers in the Economic and Political Weekly, one entitled "Understanding Inflation and Controlling it" and the other entitled "India's Foodgrain Policy, An Economic Theory Perspective." Although both have some useful but largely well known insights, unfortunately both devote too much space to largely peripheral theoretical curiosities and digressions that do not contribute to a deeper understanding of the analytics of inflation let alone on policies for addressing it.

25. Basu notes the well known steep rise in food prices and inflation globally during 1973-1974, an episode that has not been repeated in the same fashion since. He does not ask whether and why the current episode is different from the earlier one. On what he calls the divergence between the price index of food articles and the WPI since 2000, he is breathtakingly casual about the causal connection between the two. He simply asserts that in an earlier era "overall inflation was powerfully driven by the agricultural sector. Overtime, the share of agriculture in the total GDP has fallen and the growing strength of the economy (whatever he means by it), means food prices alone are no longer be in the driver's seat the way they were for the first several decades after independence".

26. Whether or not his assertion is valid, he should at least have examined the trends in relative price of food articles and the micro-economic factors in their determination. As noted earlier the time pattern of the inflation rates in the two indices differed. As noted earlier since April 2005 in 55 of the 79 months the index of food articles rose faster than that of WPI and most probably earlier as well. It is hard to argue however that the falling trend over decades of the share of agriculture in GDP, was the major contributory factor in the divergence between WPI for all commodities and that for food articles.

27. Although Basu calls for more attention to be paid to macro-demand management through fiscal and monetary policies for controlling overall inflation, his paper, including the section on interest rates and liquidity, has little or nothing to say on macroeconomic theories. His reference to Brazil having successfully lowered liquidity by counter-intuitively lowering interest rates is interesting but its relevance to the Indian context is not evident. His digression on Capital Controls and discussion on the possible impact on inflation of policies that benefit the poor such as the National Rural Employment Guarantee Act do not answer the basic question about the determinants of a sustained month-after-month rise in food prices during 2009-2010. Basu's second paper on the Economic Theory of Foodgrain management taken as a whole is extremely disappointing as a contribution to India's food-grain policy which is beyond the use buffer stocks for price stabilization and particular to the much commented upon issue of food inflation. I was disappointed that Basu, given his reputation as an excellent economic theorist failed explain the analytics of the role of India's fiscal policy in addressing inflation.

28. Deepak Mohanty, Executive Director of RBI in his very recent speeches addresses the role of monetary policy and RBI in addressing inflation. The one would like to know in the recent episode of still-on going inflation (as of October 2011) whether the

transmission mechanisms between changes in RBI's monetary policy rate namely, repo rate to its ultimate objectives might have changed and the lag between a change in repo rate and its impact on inflation rate might have lengthened. One would also like to know how the signals (on a weekly basis) on inflation rates and on a quarterly basis on growth rate that everybody including RBI receive were used in a forward looking manner by the RBI in deciding on whether to change (in either direction) its policy rate. Mohanty's speeches do not provide any clue on these critical questions. After all the RBI has changed the repo rate as many as fifteen times in the two years since March 2009, effectively tightening liquidity by 475 basis points. Yet as yet there is no perceptible impact on inflation. Besides Mohanty mentions RBI's objective of achieving a specific inflation rate as a threshold level to ensure anchoring of inflationary expectations. Since RBI does not follow inflation targeting in its monetary policy, nor does it use a fixed exchange rate of the Rupee with a low inflation country as an anchor, one would like to know how it uses in an analytical way the findings from its own periodic survey of inflationary expectations. The recent statement of the RBI that it reserves the right to intervene if necessary to address the depreciation of the Rupee seems to contradict its policy until now of letting the market forces determine the Rupee's exchange rate and intervening only to mitigate the volatility in exchange rate movements.

29. At a recent Confederation of Indian Industry (CII) event in Kolkata, Governor Subbarao acknowledged that the criticism that RBI's hikes of repo rates 13 times since March 2010 have had no impact on inflation rates is valid but added " Had the RBI not acted the inflation rate now would have been 12 percent or 13 percent and not 9.7 percent at the moment" (The Hindu, December 12, 2011). This is merely self serving assertion since he did not offer a shred of analytical evidence in support. One could equally well argue that had the RBI acted by taking bolder hikes once the evidenced that

mini hikes were not working probably inflation at the moment would have been much lower than 9.7 percent

30. Time does not permit a discussion of the paper of Mihir Rakshit that questions the macroeconomic framework of monetary and fiscal policy making in India and wants to be replaced by a structuralist one that in his view is consistent with Indian reality. He also questions the monetarist thinking behind the repo rate rises of RBI in trying to combat inflation. While analytically interesting, Rakshit unfortunately does not provide enough empirical support for his alternation framework.

31. This is not the occasion for delving into the more econometrically oriented papers and to my own admittedly simple and even simplistic, econometric exercises. My summary assessment is that they are neither conclusive nor informative and have no distinct take-away message. For example on the crucial question of whether food inflation is the driving force behind overall inflation some studies find no convincing empirical evidence in favour while others do. The fundamental problem with the studies is that they are based on ad hoc specifications without any link to economic theory.

32. However the thesis of food inflation as the driving force of inflation will soon be put to test. The weekly inflation rate in food articles has been declining recently from 12.21 percent in the week ended October 22, 2011 to 6.00 percent in the week ended in November 26, 2011. In part this is to be expected with a good Khariff Crop following a good monsoon and the beginning of market arrival of the Khariff harvest (primary) rice, price of rice declined. Wheat prices have been declining even longer perhaps following Russia's lifting of the ban on wheat exports. It is too soon to tell whether the recent decline of food inflation is temporary or will be sustained. If it is it will be interesting to

see whether overall inflation rate will begin to decline at the end of this fiscal year as the government has been forecasting.

33. I will conclude by summarizing and drawing policy implications from my analysis. Let me begin with two recent developments that have implications for economic policy in general and for addressing inflation. The first is the already mentioned good news about recent decline in food inflation. Second is the bad news about the decline in real GDP growth in the second quarter of this fiscal year to an annual rate of 6.9 percent in the first quarter's 7.7 percent. Basu has attributed this in part, perhaps euphemistically to "delays in decision making" rather than appropriately to policy paralysis. Montek Ahluwalia pointed out to an investment slowdown as the cause, but the data do not bear him out. But both did not refer to the most disturbing aspect of the decline, namely that it started from 9.4 percent in the fourth quarter of 2009-10 and has been declining in every quarter since then. In fact even the 9.4 percent growth itself is more a reflection of the recovery from the effects of the global financial crisis. In fact the slowdown that had started in the last quarter of 2007-08 before the financial crisis hit and had its impact on India. I have argued elsewhere that the structural problems, particularly of infrastructural constraints had made it unlikely a return after the crisis to the average growth rate exceeding 9 percent during the three years 2005-2008.

34. The recent decline could be a reflection of shift from the unnecessary stimulatory policy stance earlier of RBI around March 2009 and the consequent net tightening of credit by 475 basis points through successive increases in repo rates since December 2009. Though conventionally and plausibly trade-offs between growth in education and inflation moderation are associated with the rise in the interest rates, they have to be established rigorously. After all the shares of interest sensitive components of the industrial composition GDP and of aggregate expenditure are not large. In any case

Montek Ahluwalia ended a recent interview with Karan Thapar of CNN-IBI with the frank admission that “I regret to say that I have to admit that” in response to Thapar’s remark “If inflation hasn’t begun coming down by February, than the government really does not know what it is doing.”

34. Ahluwalia’s reasoning behind the likelihood of the current forecast of a decline of inflation by February 2011 being credible as compared to unrealized past forecasts is not persuasive. To say the full effects are yet to be felt is itself not credible. Why did the RBI not raise the repo rate in bigger steps as the signals from its earlier rises in repo rates were not felt even after the expected lag? I have already pointed out that the statement at the CII event by Governor Subbaaro in defense of RBI’s actual hikes was self-serving without any analytical evidence. Of course India cannot control international prices. The possibility of their going up as well as down has to be accounted for in making forward looking policy. Did the international prices go up more than had been allowed for in the government’s March 2010 forecast? The signals about the possibility of further rise in prices were there soon after March 2010 and policy could have responded. That there is a margin of error around any forecast is obvious. For this reason, a prudent forecaster would make a point rather than an interval forecast that took forecast errors into account, is inappropriate. Moreover the observed trend in one direction (upward) only in prices suggest policy failure and not just forecast errors.

### **Where Do We Go From Here**

35. It is to be fervently hoped that the recent decline in weekly inflation in Food Articles would be followed by a long-awaited decline in overall inflation. But apart from hopes and prayers, policy review, rethinking and actions are called for. Let me list some without being comprehensive and exhaustive. First, a rethinking of the framework for

analysis of inflation away from paradigms largely borrowed from developed countries and towards one that is appropriate for the Indian context is needed. In particular the fact of financial intermediation in India apparently excludes a significant shares of savings and investment in GDP needs to be taken into to assess the macroeconomic effects of the type of global financial crisis of 2008 in future. Second, the relevance to India of the foreign paradigm that monetary and the fiscal authorities pursue different objectives has to be examined for relevance without confounding it with distinct issues of independence of RBI from the fiscal authorities to set instruments under its control independently. The latter is consistent with both having the same objective for the economy with the two credibly coordinating their choices with each other. The evidence from RBI studies that there appears to be little coordination in India between then is disturbing in this context. Third, the RBI should certainly be able to transmit credibly and effectively its policy stance by explaining reasons in a forward looking manner for changes in its policy rate when it makes them. But the reasons must go beyond just for influencing short term interest rates money markets in the desired direction but more importantly for influencing one of RBI's ultimate objectives, namely sustaining growth price stability.

36. RBI has not explained why its successive increases in policy rates 13 times since March 2010 have had little apparent effect on inflation. While the Annual and Quarterly reviews of the RBI of Macroeconomic Developments and Outlook are certainly valuable, they do not meet the need for explaining reasons for policy action or non-action as major shocks domestic and external hit the economy. To take just one example, RBI to the best of my knowledge has not laid out its analysis of the Euro crisis and its assessment of proposal, for its resolution from an Indian perspective.

37. Fourth, and most important, the urgency of completing the 1991 reform agenda ought not to be underestimated. For example, fiscal consolidation, reform of the tax code, introduction of a goods and services tax, rethinking of market interventions, explicit subsidies, tax expenditures, agriculture credit, energy and infrastructure investments and policies, and going beyond them by identifying new reforms (for example, labour laws and state level regulations) remain to be completed or even begun in many cases. It should be understood first, that the lags in beneficial effect of these reforms to emerge would vary with the reform and the lags could be long in some cases and second, any delay in undertaking this task would avoidably keep people poor longer and prolong the inflationary trends.

38. Fifth, the government and Indian society in general seems to be ambivalent about a commitment to liberalizing foreign trade and investment. On the one hand Prime Minister Manmohan Singh in his speeches at the G-20 summits supported a commitment to conclude the Doha round of Multilateral Trade Negotiation with a balanced outcome. On the other, the commerce minister Anand Sharma who is India's negotiator on Doha wants to go back India's position in December 2008 when India and US together contributed to the stalling of Doha Round.

39. Recently Singh and Sharma have publicly committed to the decision of the central cabinet to allow 51 percent share of Foreign Direct Investment in India's retail trade sector. Its implementation under strong political opposition including from members of their own ruling coalition seems has been suspended it until a political consensus develops. Besides since retail trade is under the jurisdiction of states, a consensus seems implausible.

40. Sixth, fiscal consolidation to reduce consolidated fiscal deficits of the centre and states and the overall government debt to GDP ratio to sustainable levels to support rapid and sustainable growth under price stability seems a long way off. This is primarily because the government does not seem to have the requisite political support to reduce explicit subsidies, implicit subsidies through tax expenditures and to complete fiscal reform. Clearly as compared to a desirable situation in which monetary and fiscal efforts are coordinated to maintain price stability, without support from fiscal effort, the social cost of monetary authorities alone trying to achieve the goal using its own tools would be high, assuming they succeed. But their success is by no means certain.

41. The global fallout from the festering Euro Zone sovereign debt crisis has already slowed the growth rate of India's exports and as happened in 2009. Most likely it would again lead to a decline in exports in the near future, though it is hard to forecast the size of the decline. For well known reasons, any decline in exports has its major impact on growth of industrial production as is already happening, since a large share of India's exports is in manufactured products. Moreover as in the aftermath of global financial crisis of 2008 external export credit flows and flows of Foreign Institutional Investment (FII) could also decline. The recent depreciation of the Rupee could be a reflection of rationally anticipated decline in exports and FII. Already with an anticipated decline in its manufactured output China has already reversed its tightening of credit introduced for controlling inflation. I would not be surprised if RBI also reverses and lowers the repo rates soon and the government once again engages in an unnecessary stimulation effort as it did in 2009. But one cannot be sure since the Indian policy tradition is one of being re-active than pro-active!

42. Let me conclude with drawing your attention to the depth and foresight of RV's analysis of inflation and anti-inflationary policies by noting that the current finance

minister Pranab Mukherjee said in effect the same things as RV has said in his suo motu statement in Parliament on November 23, 2011. After listing the fiscal and monetary policy actions already taken he went on to describe what more needs to be done to check inflation “a durable solution to inflation in an economy with rising income levels lay in improving agricultural productivity, strengthen food supply chains and augmenting capacities in manufacturing sector in pace with the growth in demand. It requires a facilitative policy environment, increased public investments so that these measures can be actively pursued”. These tasks are almost the same as those in RV’s policy agenda three decades ago.