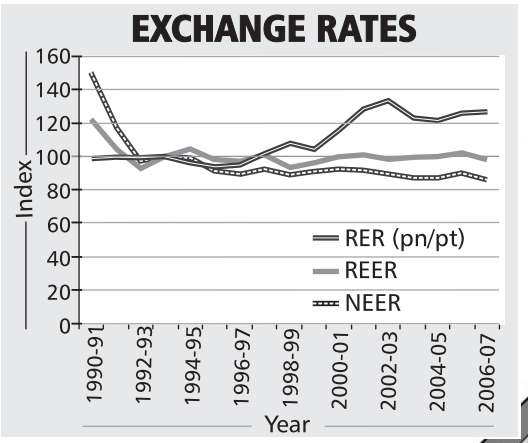


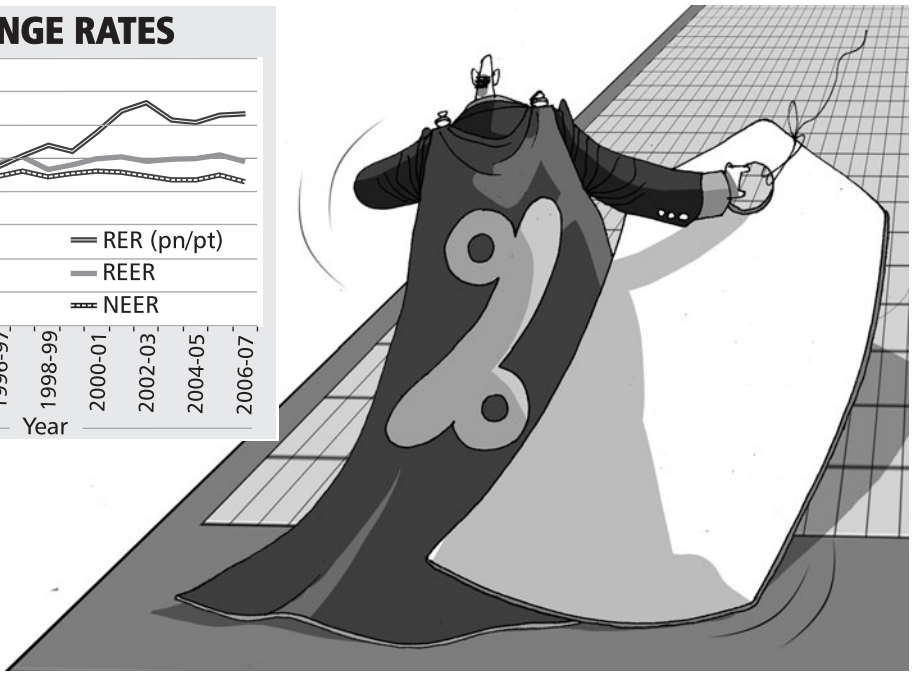

Illustration by BINAY SINHA

# The inflation scare

*The RBI should be asked to fulfil an inflationary target as its sole mandate, says* DEEPAK LAL

The fear that the recent rise in the inflation rate will scupper their chances of re-election has led the UPA government to blame the usual suspects: hoarders, monopolists, and of course, foreigners. So bring back discredited policies: raid hoarders, torment speculators and ban export of agricultural products. But raiding merchant's stocks and banning forward training merely short-circuits the inter-temporal smoothing mechanism — whereby traders make a profit by buying stocks when prices are low, and offloading their "hoards" when prices are high. Preventing farmers from benefiting from current high world prices for commodities, apart from not allowing them to become richer, also reduces their incentives to raise supplies. Even the purportedly economically literate Finance Minister has accused the domestic steel producers of monopolistic practices, when in the global economy their share (and hence control) of output is small, and hence it is inconceivable that their output decisions can influence the world price of steel.

Then, foreigners can be blamed for the high price of commodities, leading to cost-push inflation. This harks back to the Latin American "structuralist" views, which claimed that as money prices of individual goods and services were sticky, any *relative* price change could only occur through price rises and thence inflation. This view was thoroughly discredited and the old classical view that inflation is largely a monetary phenomenon was widely accepted around the world. It is this "monetarist" view of inflation which blames a presumed loosening of monetary policy by the RBI, which is now being reversed by the recent rise in the repo rate and the higher reserves banks have to hold with the RBI.

Prima facie, there seems much to commend this view. In a recent paper for the NCAER (Lal, Bery, Parida: "The Australian Open Economy Model and Macroeconomic Outcomes: India 2001 to 2007-08) it was found that whilst, till 1998-99, the monetarist model seemed to explain the behaviour of the RBI pretty well, since then it has broken down. This is largely because since then it has engaged in massive sterilisation of foreign inflows to prevent the rupee from appreciating. But, in itself, just looking at the increase in reserve money does not tell us the net effects of the monetary and fiscal stance of the authorities on nominal aggregate demand and thence on the price level. We need what economists call a "general equilibrium" model of the economy, where everything is interconnected and the effects of the change in one particular aspect affect myriad of other variables. As I have argued previously, the so-called Australian model of a small open economy provides such a model.

In this model, the domestic price level can be decomposed into two broad groups of commodities. The first are "traded", whose domestic prices are set by the foreign currency "world" prices and the nominal exchange rate (Rs 1=$x). The second are "non-traded" (like housing, infrastructure and domestic services) which cannot be exported or imported, as well as goods which could be, but because of administrative controls (as for oil) or import quotas, their domestic prices are not set by "world prices". For these foods the domestic price is set by domestic demand and supply.

The domestic price level is then a weighted average of the domestic prices of traded and non-traded goods. The former (traded) depends upon the nominal exchange rate (NER) and foreign currency prices. Thus the effects of a rise in foreign currency price of imports can be fully offset by an equivalent appreciation of the NER. The latter (non-traded) will depend upon the equilibrium real exchange rate (RER) in the economy, defined as the relative price of non-traded to traded goods. This cannot be controlled by the authorities. It is established as a result of the general equilibrium effects to three factors: inflows of foreign capital and remittances; excess aggregate demand; and changes in the terms of trade (TOT- foreign currency prices of traded goods). The first two factors lead to RER appreciation as does a worsening of the TOT. The NCAER series of the RER is the only one available for India. It is different from the RBI's and IMF's real effective exchange rate (REER). These 3 series are charted in the Fig.

An inappropriate assignment of the NER, which (for any foreign currency price change) determines the domestic price of traded goods, can then lead to a rise in the price level. Thus we estimate that, in 2004-05, when there was a large terms of trade loss of -10.9%, which would have required an RER appreciation. But, the minuscule increase in capital flows counterbalanced by a small fall in excess demand would possibly have required a small fall in the RER. However, the RBI inappropriately kept the NER stable, allowing traded goods prices to rise by 7%, which then required non-traded goods prices to rise by about 6% to yield the small fall required in the RER. But the domestic price level rose as a result by nearly 7%.

Similarly, we conjecture that, in 2007-08, the large fall in the TOT would have required a substantial appreciation of the NER, for which the actual rise of 8% was insufficient, leading to a 5% rise in traded goods prices. But as the rise in capital inflows was counterbalanced by an equivalent fall in excess demand, the required fall in the RER of about 3% was accommodated by a small rise in non traded goods of 2.4%, leading to an overall inflation rate of about 4.4%.

The lessons from our exercise are 1) it is not excess demand, but the inappropriate assignment of the NER (which in turn affects the price of non-traded goods to establish the equilibrium RER) which is largely responsible for the recent inflation scare; 2) as the extent and even direction of the requisite NER changes in the face of exogenous shocks is uncertain, it would be best to adopt a fully floating NER. Third, instead of the current muddled macro-economic framework, the RBI should be made independent and asked to fulfil an inflationary target as its sole mandate.