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Epitomising Inflation and Growth: Lessons from India

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Epitomising Inflation and Growth: Lessons from India

Charan Singh[1]

Since 2020, the global economy has been serially hit by a multitude of shocks. The global output, which had already been weakened by the COVID 19 pandemic, has further deteriorated due to a combination of exogenous shocks and endogenous events. These include the Russia-Ukraine war, continuation of COVID-19 lockdowns in China, higher fuel and commodity prices etc. Inflation, driven by diverse causes, has become an important risk factor in recent times.

The World Economic Outlook (WEO) by the International Monetary Fund (IMF), released in October 2022, forecasts a slow down in global growth from 6.0 percent in 2021 to 3.2 percent in 2022 and further down to 2.7 percent in 2023. On the other hand, global inflation is expected to rise from 4.7 percent in 2021 to 8.8 percent in 2022 and decline to 6.5 percent by 2023 and to 4.1 percent by 2024. High Inflation may prove detrimental to growth dynamics of any country, since there are negative implications for fundamental issues such as lowering employment rate, eroding real income, distorting purchasing power etc.

This paper has been divided into eight sections. Section 2 provides the current global growth scenarios and compares the future prospects for Advanced Economies (AEs) and Emerging Market Economies (EMEs). Section 3 evaluates the fiscal stimulus undertaken by various nations during the time of COVID-19 outbreak, with special reference to India. Section 4 explores global inflationary trends and the monetary policy responses to it. Section 5 examines the global inflationary dynamics and the implications of monetary policy responses on economic growth. Section 6 looks at the economic scenario in India and its particular inflationary trends. Section 7 carries out an analysis of the inflation targeting approach in India and its pitfalls. Section 8 presents the conclusion.

[1] CEO, EGROW Foundation

2: Global Growth Scenario

The growth rate projections of AEs by IMF's WEO of October 2022 shows that despite the recovery from COVID-induced economic distress through fiscal support, AEs have seen a slowdown since 2021 and are expected to see a continuing decline in 2023 (Table 1). The 2018 levels are not expected to be restored even by 2027 and therefore, AEs could lose an entire decade to stagnation and the situation looks rather dire.

Table 1: GDP Growth Projections - Advanced Economies

(percent)

Countries	2018	2019	2020	2021	2022	2023	2027
AEs	2.3	1.7	-4.4	5.2	2.4	1.1	1.7
USA	2.9	2.3	-3.4	5.7	1.6	1	1.9
UK	1.7	1.7	-9.3	7.4	3.6	0.3	1.5
Germany	1.1	1.1	-3.7	2.6	1.5	-0.3	1.3
France	1.8	1.9	-7.9	6.8	2.5	0.7	1.4
Australia	2.8	2.0	-2.1	4.9	3.8`	1.9	2.3
New Zealand	3.4	2.9	-2.1	5.6	2.3	1.9	2.4

Source: WEO, IMF, October 2022.

Among the BRICS countries, major economies like Russia and China have been witnessing volatile conditions as well (Table 2). India, however, remains an exception with its stable domestic economic framework and cautious approach. It can also be seen that the growth projections for India are much better compared to both AEs and other EMEs. India could potentially be the engine of global growth for the next decade which is a result of calibrated policy decisions taken in the past.

Table 2: GDP Growth Projections - Emerging Market Economies

(percent)

Year	2018	2019	2020	2021	2022	2023	2027
EMEs	4.6	3.6	-1.9	6.6	3.7	3.7	4.3
Russia	2.8	2.2	-2.7	4.7	-3.4	-2.3	0.7
Brazil	1.8	1.2	-3.9	4.6	2.8	1.0	2.0
China	6.8	6.0	2.2	8.1	3.2	4.4	4.6
India	6.5	3.7	-6.6	8.7	6.8	6.1	6.2
South Africa	1.5	0.1	-6.3	4.9	2.1	1.1	1.4

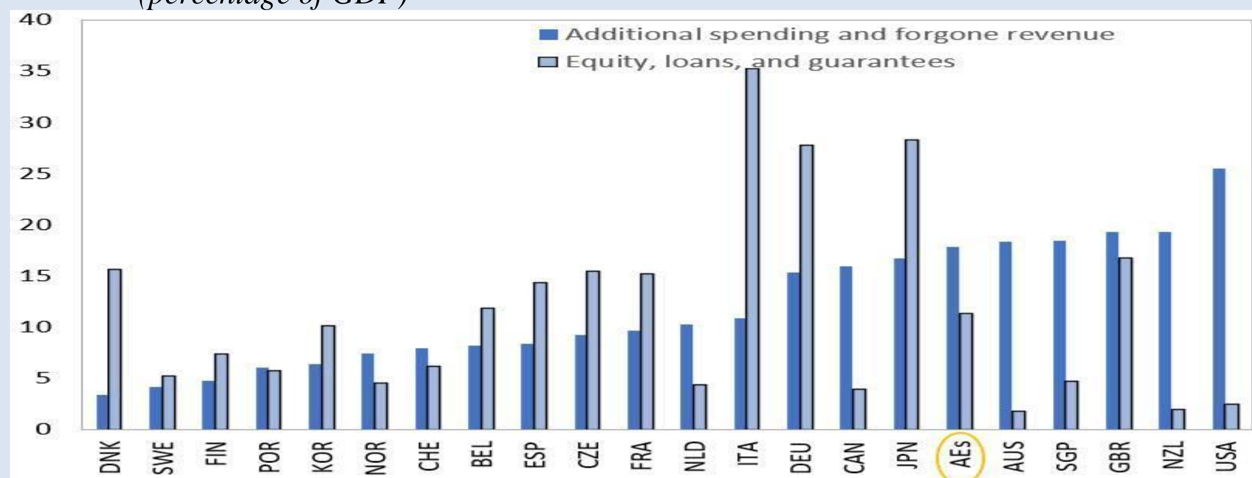
Source: WEO, IMF, October 2022.

3: Fiscal stimulus in times of COVID-19

In the COVID-19 pandemic, almost all countries adopted a policy of greater government intervention to support the economy. Overall, AEs are spending 17 percent of their GDP (2020) in terms of additional revenue foregone and an additional 2.4 percent of GDP in terms of equity, loans and guarantees. The USA alone, had spent 25.5 percent of its GDP (2020) in terms of fiscal spending and additional revenue foregone, and an additional 11 percent of GDP in terms of equity, loans and guarantees (Chart 1).

Chart 1: Fiscal stimulus provided by AEs during COVID-19 crisis

(percentage of GDP)

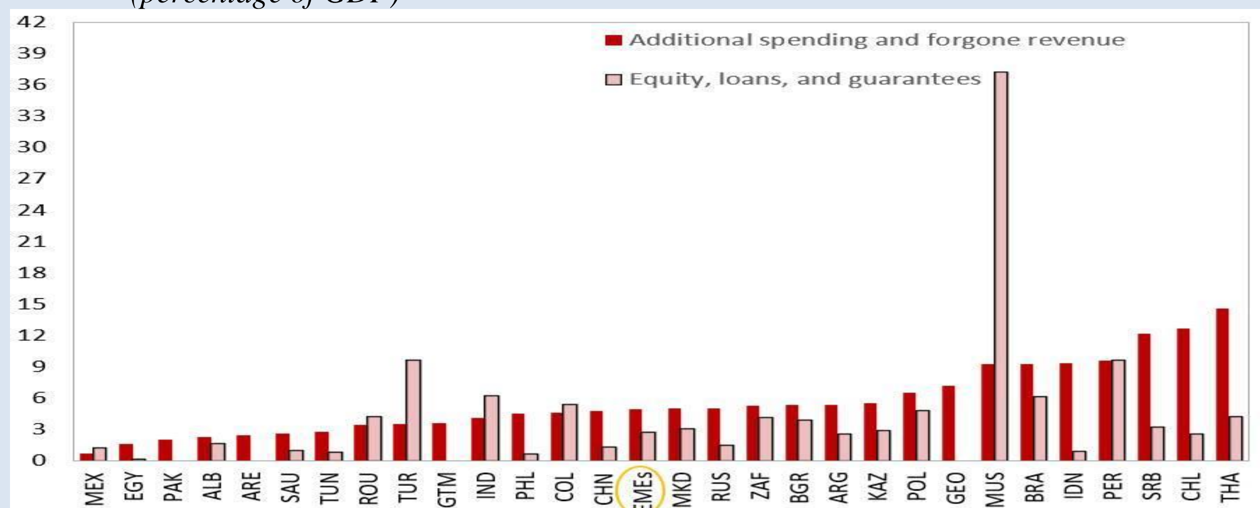


Source: Database of Fiscal Policy Responses to COVID-19, IMF, 2022

The emerging economies had spent around 5 percent of their GDP (2020) in terms of additional revenue foregone and 3 percent of GDP in terms of equity, loans and guarantees. China spent around 4.8 percent of its GDP (2020) in terms of additional revenue foregone and 1.3 percent of GDP in terms of equity, loans and guarantees. India, had spent 4.1 percent of its GDP (2020) in terms of additional revenue foregone and 6.2 percent of GDP in terms of equity, loans and guarantees (Chart 2). Despite providing less quantum of stimulus, in relation to other comparable economies, India has emerged as the bright spot in the global economic recovery path. It was the unique stimulus strategy that put India on a path to faster and sustainable recovery.

Chart 2: Fiscal stimulus provided by EMEs during COVID-19 crisis

(percentage of GDP)



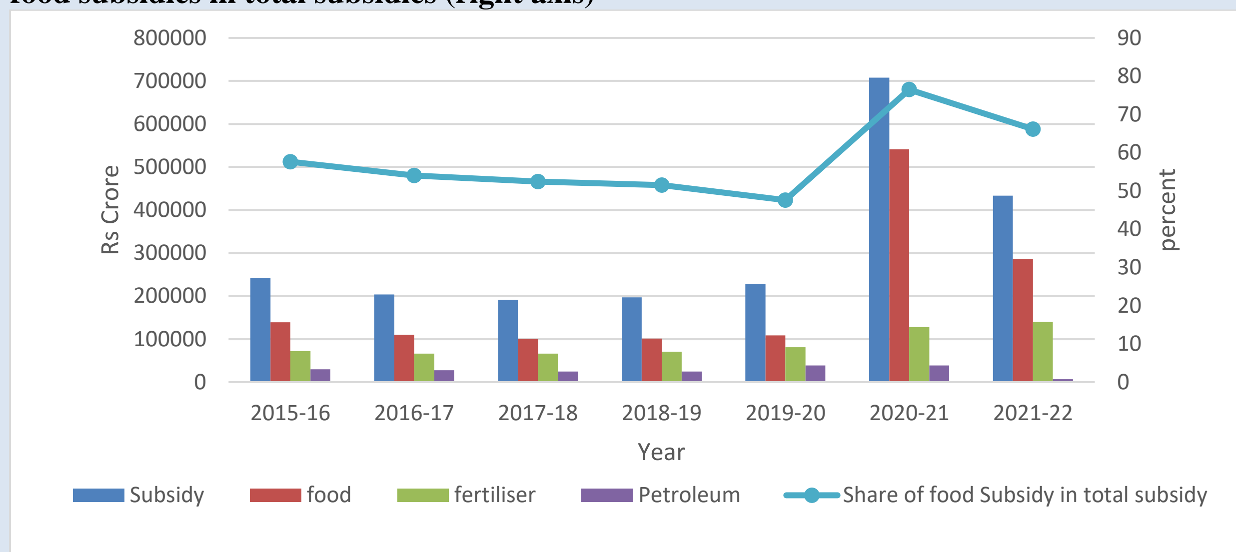
Source: Database of Fiscal Policy Responses to COVID-19, IMF, 2022

India adopted an optimising, laser-beamed and agile approach to provide COVID-19 stimulus, prioritising safety nets and livelihoods in the initial stages of lockdown and eventually shifting focus to reviving the economy through sectoral support and capital expenditure. India pursued a "Barbell Strategy" of in-kind fiscal stimulus, that combined a bouquet of safety-nets to cushion the impact on vulnerable sections of society/business, with a flexible policy response based on a Bayesian updating of information. The ultimate aim of this strategy was targeted outcomes for marginal sections of the society, both in the short as well as the medium term. Such an aim was pursued using a three pronged spear of food subsidies, livelihood support and health support in the initial phase, and stimulating economic growth in the medium term.

In the initial period of lockdown, beginning from March, 2020, the stimulus encompassed measures such as expansion of food subsidy and providing livelihood to the people worst

affected due to lockdown. Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY), which has so far been rolled into seven phases, provided free 5 kg of food grains per month to 80 crore beneficiaries. In 2020-21, food-subsidy constituted 76.4 percent of all subsidies granted as compared to an average of 50 percent in preceding years (Chart 3).[2]

Chart 3: Amount spent on subsidies by Central government (left axis) and the share of food subsidies in total subsidies (right axis)



Source: Various budget documents, GoI, 2021-22.

PMGKAY was aimed to provide a security net to the poor households that underwent suffering and financial losses during the lockdown through cash-transfers and in-kind benefits (ration shops). In the wake of supply chain disruption caused due to lockdown, the government adopted a technologically robust Public Distribution System (PDS) with an automated supply chain management and Aadhaar seeding of around 100 percent of the National Food Security Act (NFSA) 2013 ration cards. One Nation, One Ration Card (ONORC) Scheme was leveraged to ensure portability of ration cards, especially for migrant workers.[3] The easing of inter-state supply chain constraints for essentials like food grains kept prices at pre-pandemic levels and enabled food security during COVID-19. A study under IMF concluded that such measures were instrumental in ensuring that extreme poverty remained low at around 0.8 percent, as was the case in pre-pandemic scenarios and inequality remained near the lowest level, at 0.294.

In order to prevent a crisis of livelihood, Mahatma Gandhi National Rural Employment Guarantee Act 2005 (MGNREGA) was ramped up. MGNREGA ensures right to livelihood in

[2] Budget Documents, GoI, 2022-23
[3] Press Release, Press Information Bureau, GoI https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1742772

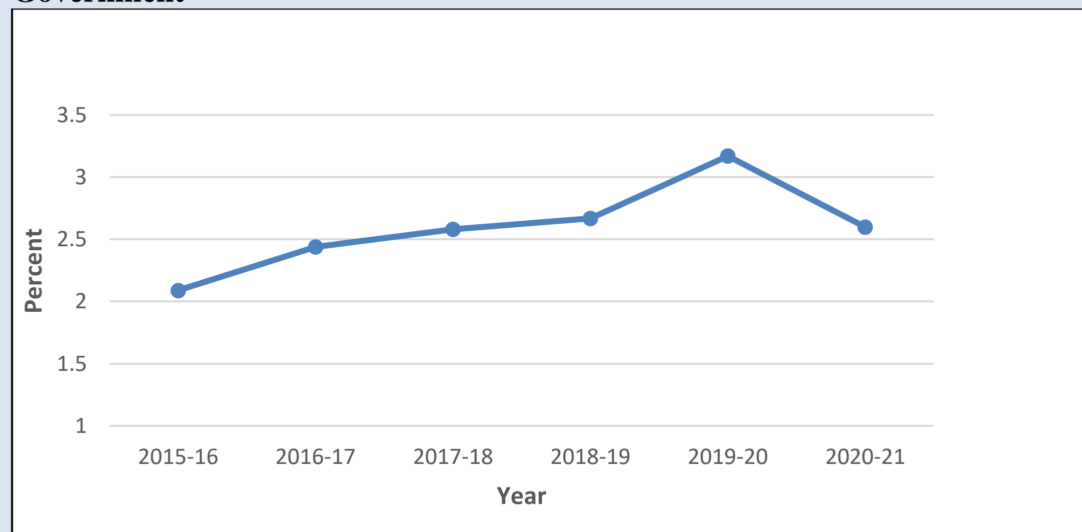
rural areas, with 100 days of guaranteed unskilled labour. MGNREGA allocation rose by 55.1 percent in 2020-21 (Table 3). As a result, its share in total expenditure rose from 2.6 percent to 3.1 percent within a year. In the year 2021-22, MGNREGA allocation was increased from Rs 98000 crore, which constituted 2.6 percent of the expenditure (Chart 4). This provided the required immediate support to the rural economy.

Table 3: MGNREGA expenditure and growth rate

Year	Real Expenditure (Rs crore)	Growth rate (percent)
2015-16	30827.2	
2016-17	38555.9	25.1
2017-18	42430.2	10
2018-19	45766.5	7.9
2019-20	51836.3	13.3
2020-21	76122.5	46.9

Source: Computed by author from various Budget documents, GoI

Chart 4: Share of expenditure on MGNREGA in total budget expenditure of Central Government



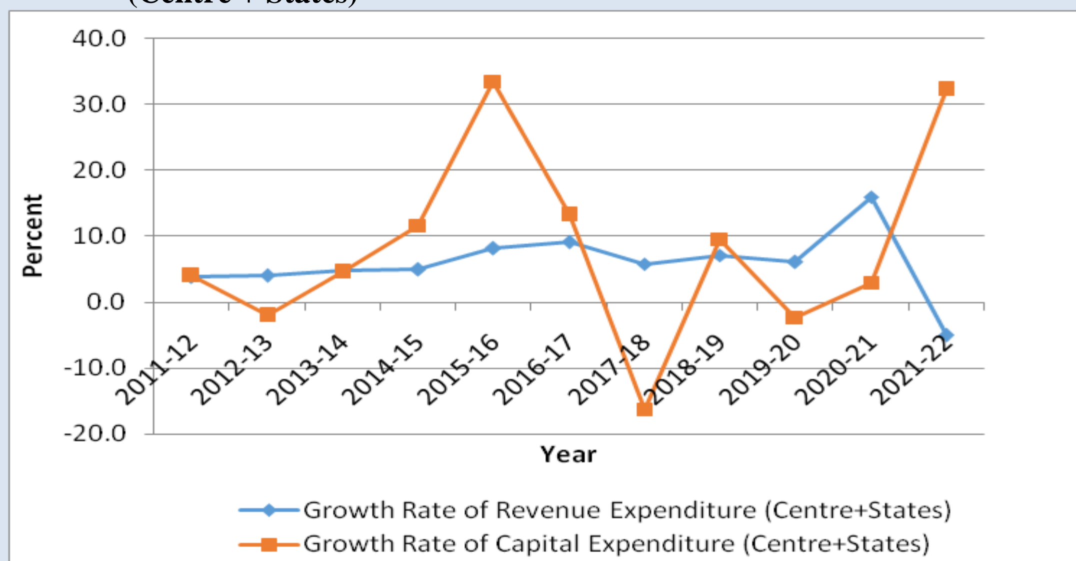
Source: Computed by author from various Budget documents, GoI

Fiscal support to the health care sector was provided through 'COVID-19 Emergency Response and Health Systems Preparedness Package' of Rs 15000 crore. The aim was to reduce inequity in access to healthcare services, ramping up supply of essential material like PPE kits, face masks, training of health workers and increasing capacities of existing healthcare infrastructure. Meanwhile, efforts focused on working closely with the private sector to

accelerate development of COVID-19 vaccine. Mission Suraksha was launched to enable R&D in vaccines.[4] In 2021-22, the government allotted Rs 35000 crore for COVID-19 vaccination program. The vaccination program was implemented in a phased manner, with healthcare workers, elderly and people with comorbidities given priority. This ensured time and equitable distribution of vaccines to people.

In later phases, the focus of the stimulus gradually shifted to propelling the economy and sustaining growth in the medium and long term. Therefore, the focus shifted to boosting investment through Production Linked Incentives (PLI), greater investment in infrastructure through National Infrastructure Pipeline, National Asset Monetization Plan and public investment in the health sector. The focus on capital expenditure was carried forward in the subsequent quarters as a result of which, the share of capital expenditure in total government expenditure reached highest since 2008-09 at 16 per cent in 2021-22 (Chart 5). This led to better quality of fiscal deficit[5] (Chart 6).

Chart 5: Growth rates of Real Revenue Expenditure and Capital Expenditure (Centre + States)

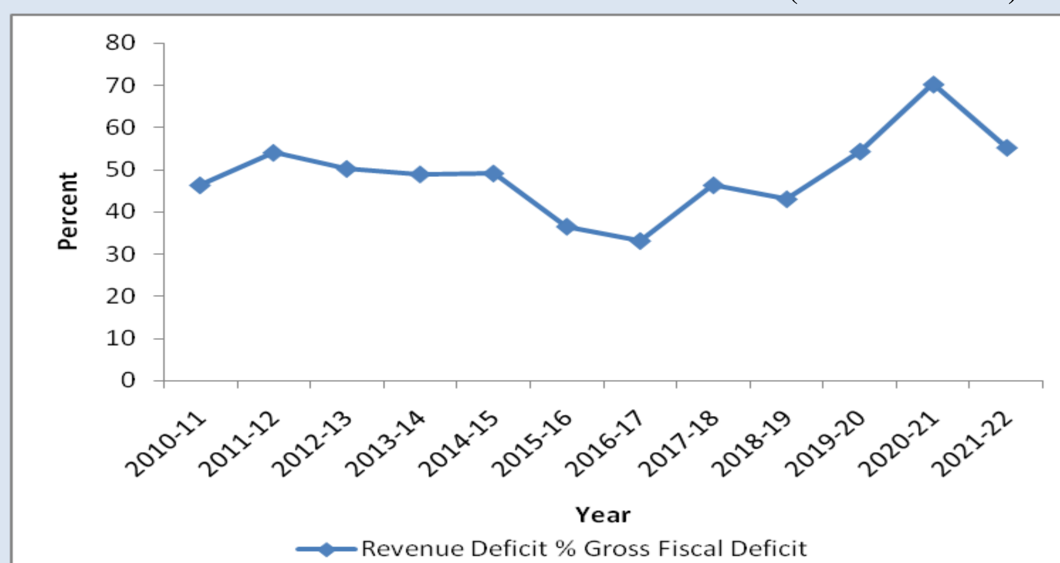


Source: Computed by author based on data from Handbook of Statistics on Indian Economy, 2021-22, RBI

[4] Press Release, Press Information Bureau, GoI https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1676998#:~:text=Government%20Launches%20Mission%20COVID%20Suraksha%20to%20accelerate%20Indian%20COVID%2D19%20Vaccine%20Development&text=The%20Government%20of%20India%20(GOI,COVID%2D19%20Vaccine%20Development%20Mission.

[5] A good quality fiscal deficit implies lower share of revenue deficit in it

Chart 6: Share of Revenue Deficit in Gross Fiscal Deficit (Centre + States)



Source: Computed by author based on data from Handbook of Statistics on Indian Economy, 2021-22, RBI

Another aspect to be considered is the quantum of fiscal deficit. A comparison with select economies of the world suggest that India performed considerably well in controlling fiscal expansion in the times of crisis. Indian general government GFD expanded by 5.3 percentage points over previous year in 2020, while for some advanced economies, like Canada and United Kingdom, fiscal expansion was as high as 11.4 and 10.6 percentage points over the previous year.[6] In case of general government debt as well, the debt to GDP ratio increased by 18.7 percent y-o-y in 2020. This is well below the USA and Canada, where it grew by 23.6 and 53.1 percent respectively.

4: Global Inflationary Trends

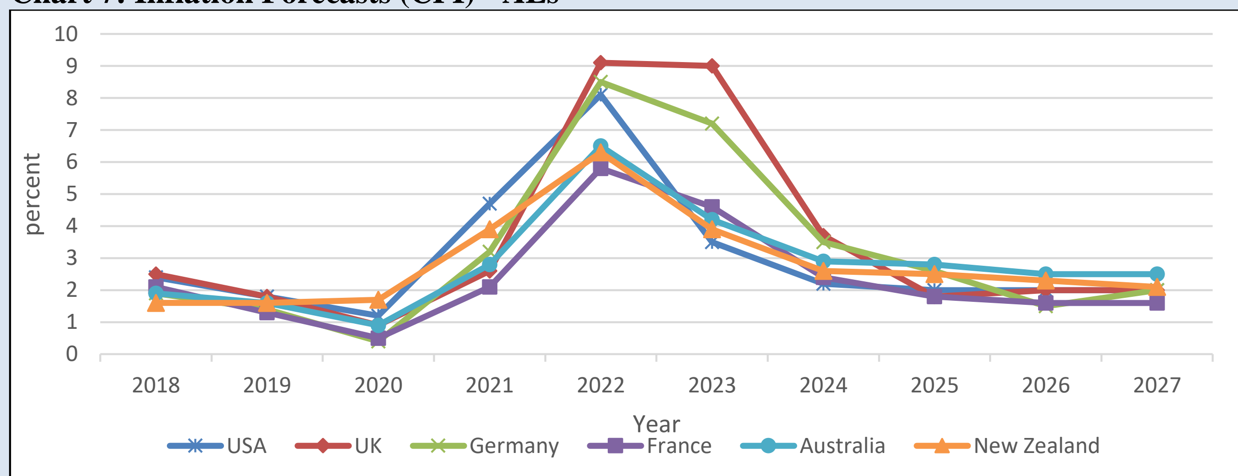
The key policy objective of central banking is price stability, and the concept of giving it a numerical precision was considered very modern after monetary and exchange rate targeting had failed in the 1980s. After many trials and initial success, the inflation targeting regime, explicitly or implicitly, was finally accepted in most countries of the world. In the last few years before the pandemic hit in 2020, the world experienced low inflation rates generally in the range of 1 percent to 2 percent. However, since the last one year, inflation has again raised

[6] The percentage points were used since y-o-y growth rates were spurious results due to base effect which were difficult to compare.

its dragon-head and has become an important risk factor, especially in most Advanced Economies (AEs). Tackling the dual challenge of declining growth and rising inflation requires a clear analysis of both the global and domestic scenarios.

In AEs, inflation levels have crossed the threshold of inflation, which is typically around 1 to 3 percent (Chart 7). In the U.S, for example, inflation has increased from 1.2 percent in 2020 to 4.7 percent in 2021 and 8.1 percent in 2022. The U.K's inflation levels are even more concerning as it is expected to reach 9.1 percent in 2022, from 2.6 percent in 2021. These worrying leaps in inflation levels are also seen in countries like Germany, France, Australia and New Zealand.

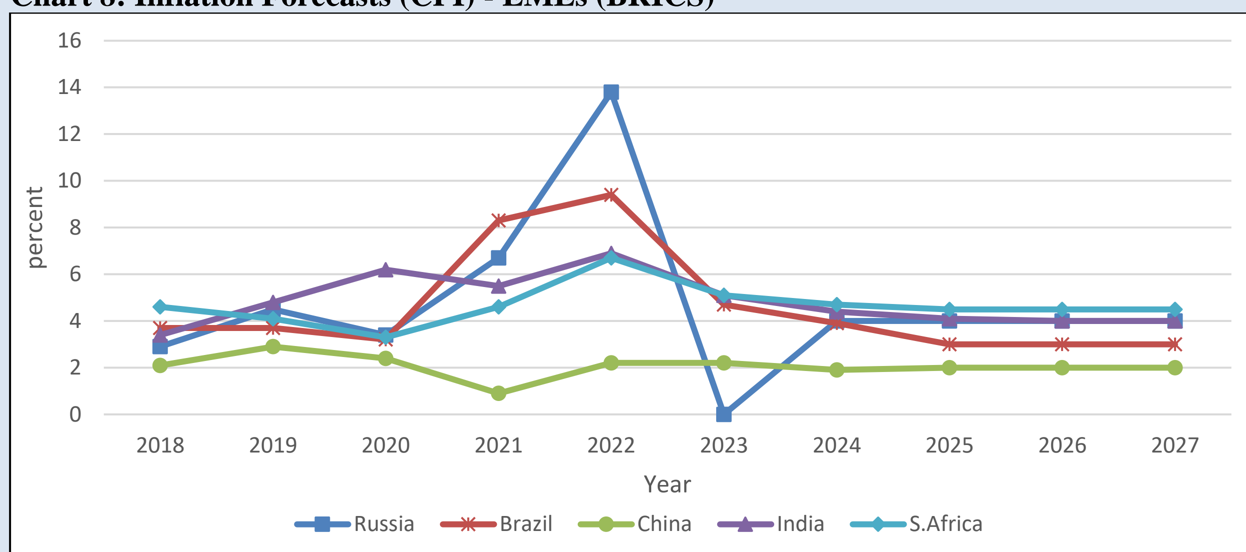
Chart 7: Inflation Forecasts (CPI) - AEs



Source: WEO, IMF, October 2022

Inflation forecasts of EMEs, specifically BRICS countries, show that similar inflationary pressures are building up in these countries too (Chart 8). However, most countries have managed to keep the inflationary levels within their threshold limits or targets - which is typically within the range of 7 to 11 percent for EMEs. However, Russia has seen its inflation levels rise to 13.8 percent in 2022, from 6.7 percent in 2021. Further, China has managed to keep their inflation levels within the target of 3 percent, with consumer prices expected to be around 2.2 percent in 2022 as well as 2023. In India, on the other hand, the upper tolerance limit of 6 percent has been breached, and is expected to reach an annual rate of 6.9 percent in 2022, from 5.5 percent in 2021.

Chart 8: Inflation Forecasts (CPI) - EMEs (BRICS)



Source: WEO, IMF, October 2022

4.1: Factors Contributing to Inflation

A large number of factors are responsible for the sharp rise in prices, like supply chain disruptions, commodity price shocks, ultra-expansive monetary policy in the USA, liberal fiscal policy in most AEs, pent-up consumer demand and changes in consumer preferences. Persistent inflation has prompted aggressive monetary tightening in AEs during the last few months, which induced capital outflow from EMEs accompanied by currency depreciation. Global economic growth is expected to slump by the end of 2022 and early 2023, with surging inflation, rising interest rates and supply side disruptions caused by the war in Ukraine. According to the World Bank's *Global Economic Prospects* Report (2022), 'Several years of above-average inflation and below-average growth are now likely, with potentially destabilising consequences for low- and middle-income economies. It's a phenomenon—stagflation—that the world has not seen since the 1970s'.

The economic recovery since 2021 also brought an increase in demand for labour in many sectors. Initially, labour was slow to respond because of ongoing health reasons and difficulties in finding child and family care services impacting female labor force participation. This imbalance in demand and supply of labour led to wage pressure with average wage increasing while unemployment started declining. A unique situation emerged with rising inflation, positive nominal wage growth, declining real wages and rising employment, in many

economies, especially the USA. This cycle of wage price spiral persisting over many quarters is unique to macroeconomic analysis, as earlier, the spiral typically did not last long, and real wages remained unchanged. In the case of other AEs, like Britain and countries in the Euro area, higher energy and food prices contributed significantly to inflation.

Theoretically, there is a positive relationship with inflation expectations and wage setting process. Therefore, to control inflation, it is important to anchor inflation expectations at moderate levels which the AEs are attempting through aggressive hike in policy interest rates. This is not an easy task as inflation has been high in different countries for varied reasons – (a) Shock to production capacity due to lockdown and social distancing; (b) International trade costs due to increasing shipping costs; (c) Commodity prices especially energy and food prices accentuated by the Russia-Ukraine war; (d) Increase in private savings; (e) Changes in composition of consumption; (f) Liberal Fiscal policy support during Covid, and (g) Unprecedented Monetary policy expansion in most AEs, especially US, UK and Euro. Empirically, evidence suggests that supply chain inflationary shocks have a temporary effect on inflation and wage growth and do not lead to wage price spiral. If inflation expectations are anchored tightly, then supply chain shocks do not have long lasting impact.

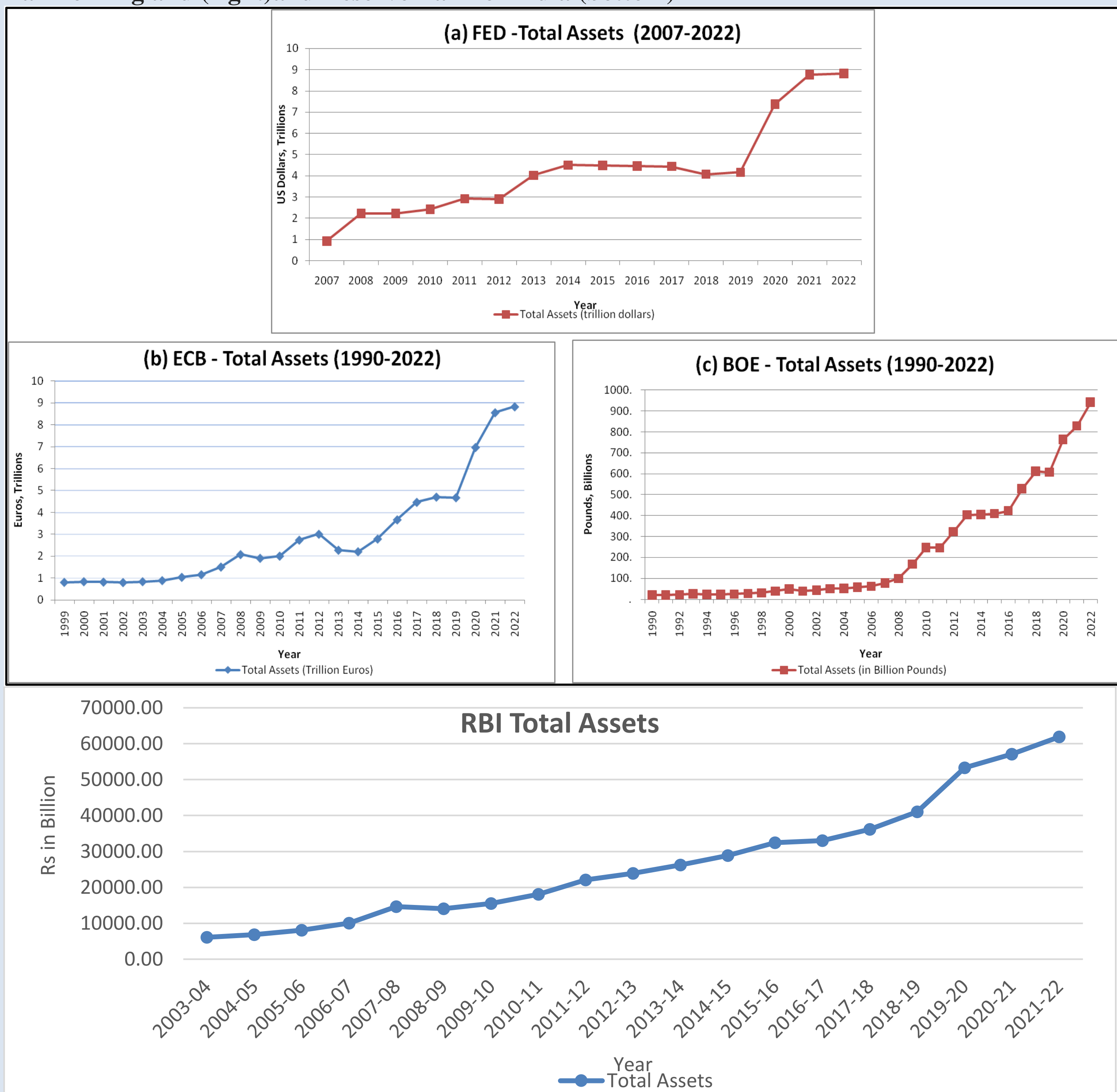
4.2: Scenario in AEs

The major cause behind rising inflation in the AEs can be attributed to quantitative easing or the ultra-expansive monetary policy that dramatically expanded the balance sheets of central banks in these countries. This rapid and unbridled printing of money to stimulate growth has invariably led to increased money supply, thereby pushing the prices and inevitably creating inflationary pressures that ripple around the world markets.

The inflation targeting approach adopted in AEs 1990s, has led to the central banks being mechanically tied to a single function of inflation management, often at the cost of its regulatory functions as well as role pertaining to overall macroeconomic stability, which is often tied to indicators such as external sector, banking and real sector. The cost of such neglect was visible during the global financial crisis (2008), when the Fed failed to anticipate the crisis brewing under unhindered flow of debt to subprime borrowers and sophisticated.

The response to the financial crisis was based on notions of money supply being the supreme variable for stabilisation of the economy. In the US, the Federal Reserve had quadrupled its balance sheet assets right after the collapse of Lehman Brothers (2008) and they doubled their balance sheet again right after COVID-10 pandemic struck in 2020 (Chart 9). Similar expansionary trends can be seen in European Central Bank's balance sheets as well as in the Bank of England (Chart 9). However, an examination of Reserve Bank of India's balance sheet shows that it has increased its assets in a limited manner.

Chart 9: Balance Sheet Trends - Federal Reserve (top), European Central Bank (left) and Bank of England (right)and Reserve Bank of India (bottom)

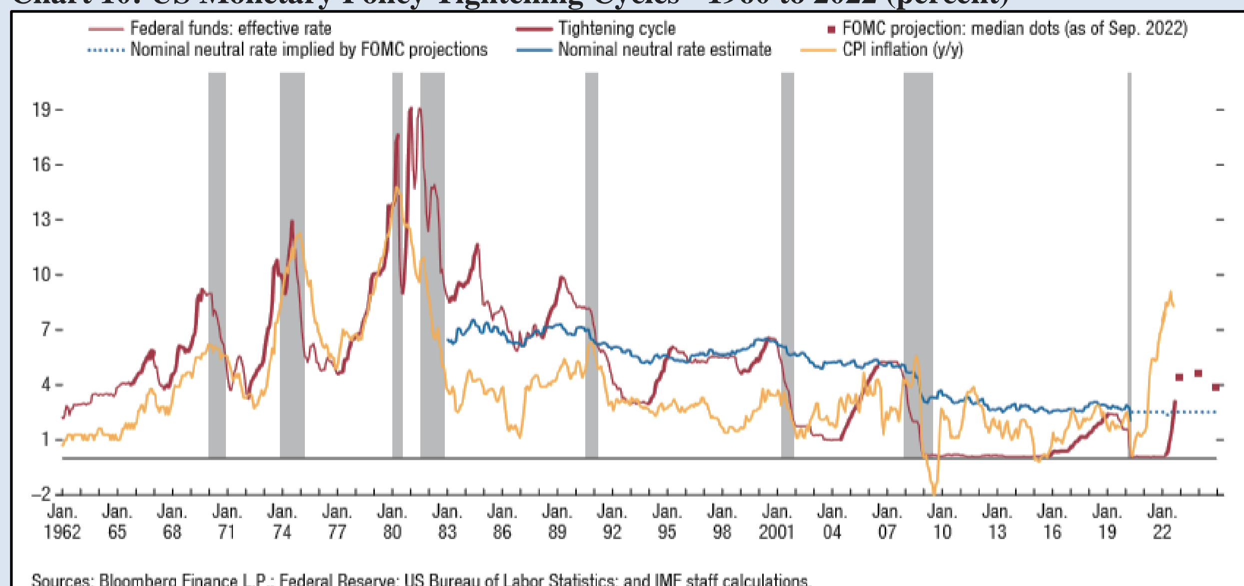


Source: Fed; ECB; BoE, RBI, 2022

5: Implications for Growth

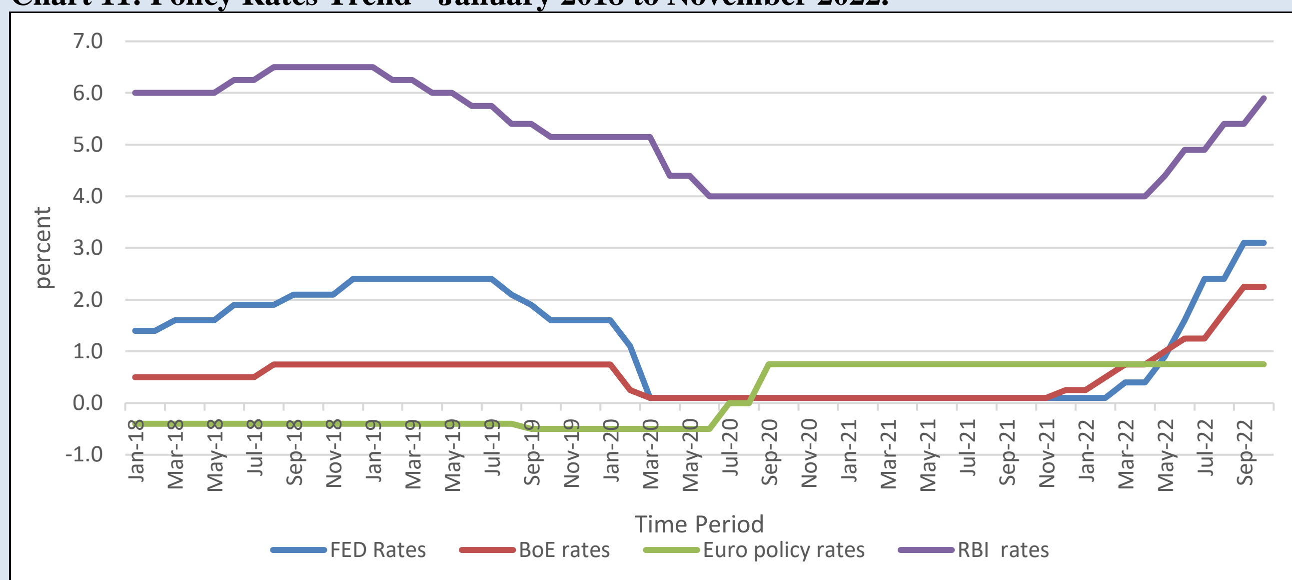
Expansionary monetary policy by the AEs have invariably ushered in eras of high inflationary periods in AEs, and surge in capital flows to EMEs like India. To control the rising prices, the countries resort to monetary tightening. Monetary tightening typically entails the raising of interest rates, which raises the cost of borrowings and thereby slows down the economy by weakening demand. A look at the history of US monetary policy trends (Chart 10) will tell us that recessions of varying degrees have always followed monetary tightening cycles in the US. The only exception to this was in 1994 when the Fed managed a 'soft landing', which can be attributed to a relatively low inflation and a quick reversal (within a year) of the tightening after hitting its peak.

Chart 10: US Monetary Policy Tightening Cycles - 1960 to 2022 (percent)



The Federal Reserve has been raising the benchmark interest rate aggressively since May 2022. The Fed has raised the policy rate by 350 basis points since May as inflation soared from 1.67 percent in February 2021 to 9.1 percent in June. Similarly, the European Central Bank (ECB) and the Bank of England (BOE) have raised the policy rates by 125 basis points each during the period. RBI too has raised benchmark repo rate by 190 basis points since May, 2022. Monetary tightening by the central banks of major AEs often make central banks of emerging economies, like Reserve Bank of India (RBI), follow suit by hiking the rates in tandem (Chart 11).

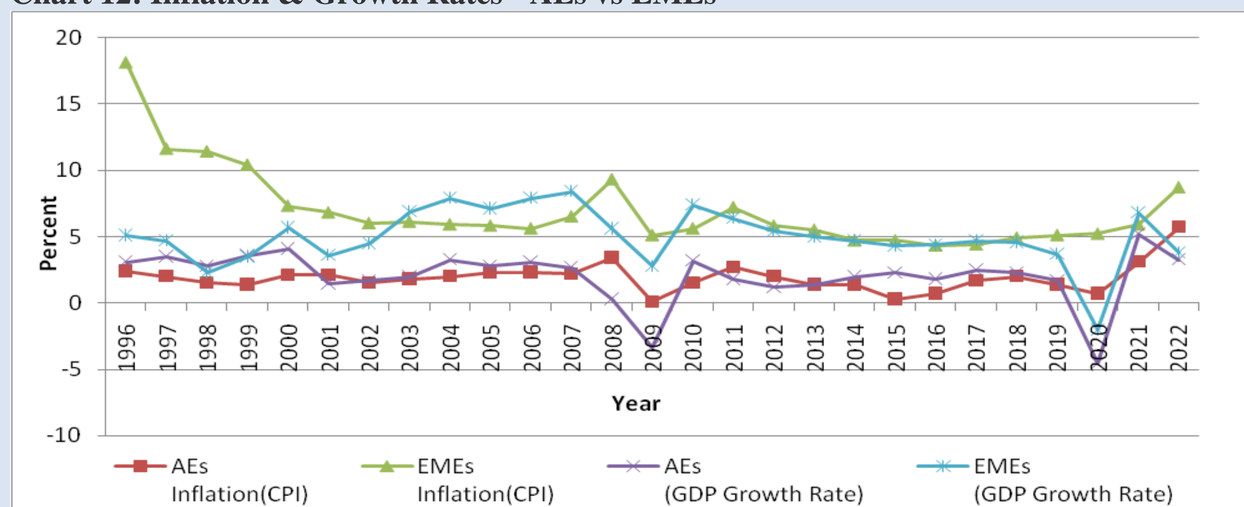
Chart 11: Policy Rates Trend - January 2018 to November 2022.



Source: RBI, FED, ECB and BoE, 2022

Monetary tightening by the AEs typically induce capital outflow from the EMEs, as the interest rate differentials make India and other EMEs less attractive for investors. This capital outflow weakens the domestic currencies like rupee, and the trust in dollar and dollar-denominated investments are reinforced. India has never been immune to the monetary tightening cycles of the Fed. Studies have shown that India has slowed by 1.5 - 2 percent even in normal Fed-engineered recessions when there were no other domestic macroeconomic stability concerns. The historical growth trends and inflation levels in AEs and EMEs (Chart 12) depict the same.

Chart 12: Inflation & Growth Rates - AEs vs EMEs



Source: IMF Database, 2022

A comparative picture of the decadal growth rates and the corresponding inflation during the same period, in AEs (Tables 4a and 4b) and EMEs (Tables 5a and 5b) shows historically, AEs have had lower rates of inflation as compared to EMEs . Correspondingly, the growth rates in AEs are relatively lower than the growth rates in EMEs. There are a multitude of factors behind these differences, but AEs as early starters had more stable and consistent economic growth and therefore relatively lower levels of inflation over the years. Since EMEs are characterised by different circumstances, it is not correct to impose the policy imperatives of AEs onto the economic and policy frameworks of EMEs.

However, global economic processes are intrinsically interlinked and the actions by AEs have consequences for EMEs. The decadal average growth rates in AEs (Table 4a) and the inflationary trends (Table 4b) during the same period shows the attempt by AEs in taming inflation by raising interest rates have negative implications for growth, and this sacrifice ratio is reflected in the growth rates of EMEs (Table 5b), which are not as equipped as AEs to handle the impacts of the sacrifice ratio. Thus, given the impact the monetary policy of AEs have on inflation and growth of EMEs, there is a need for AEs central banks to act in a more sophisticated and responsible manner for global economic recovery.

Table 4a: Decadal Average Growth Rates: AEs

(percent)

Countries	1961-62-1970-71	1971-72-1980-81	1981-82-1990-91	1991-92-2000-01	2001-02-2010-11	2011-12-2020-21
United States	4.2	3.2	3.3	3.4	1.8	1.6
United Kingdom	3.4	2.2	2.9	2.5	1.5	0.9
Euro area	-	3.5	2.4	2.3	1.2	0.6
Germany	-	2.9	2.3	1.9	0.9	1.1
France	5.7	3.6	2.5	2.1	1.3	0.4
Australia	5.1	3.0	3.4	3.3	3.1	2.4
New Zealand	-	1.3	1.9	3.1	2.6	2.6

Source: World Bank Database, 2022

Table 4b: Decadal Average Inflation (CPI) – AEs

(percent)

Countries	1961-62-1970-71	1971-72-1980-81	1981-82-1990-91	1991-92-2000-01	2001-02-2010-11	2011-12-2020-21
United States	2.8	7.9	4.7	2.8	2.4	1.7
United Kingdom	4.1	13.8	6.2	2.9	2.1	1.9
Euro area	3.1	9.5	5.8	3.4	2.3	1.2
France	4.0	9.7	6.3	1.7	1.7	1.0
Germany	2.6	5.1	2.6	2.4	1.6	1.3
Australia	2.5	10.5	8.1	2.2	3.0	1.9
New Zealand	3.8	12.5	10.8	1.8	2.7	1.5

Source: World Bank Database, 2022

Table 5a: Decadal Average Growth Rates: BRICS

(percent)

Countries	1961-62-1970-71	1971-72-1980-81	1981-82-1990-91	1991-92-2000-01	2001-02-2010-11	2011-12-2020-21
Brazil	6.2	8.7	1.7	2.6	3.7	0.3
Russian Federation	-	-	-3.0	-3.6	4.9	1.3
India	4.0	3.1	5.6	5.6	6.8	5.1
China	5.0	6.2	9.3	10.5	10.6	6.8
South Africa	5.7	3.4	1.5	1.8	3.5	0.8

Source: World Bank Database, 2022

Table 5b: Decadal Average Inflation (CPI) – BRICS (percent)

Countries	1961-62-1970-71	1971-72-1980-81	1981-82-1990-91	1991-92-2000-01	2001-02-2010-11	2011-12-2020-21
Brazil	-	-	613.8	549.2	6.7	5.6
Russian Federation	-	-	-	197.0	12.6	6.5
India	6.3	8.2	9.0	9.1	6.3	6.3
China	-	-	11.8	7.5	2.2	2.5
South Africa	2.9	10.7	14.7	9.0	5.3	5.1

Source: World Bank Database, 2022

6: The Scenario in India

In sharp contrast to most countries in the world, India's economy has been performing relatively well in recent years. India is the fastest growing economy despite the COVID-19 and all forecasts show the growth trend will be steady for next two years, relative to major AEs and EMEs (Table 1 and Table 2). An overview of the decadal growth rates and inflation levels in India also shows that India because of its strong domestic fundamentals has fared better in terms of steady growth and controlled inflation, despite disruptive global environments (Table 6, Chart 13). Inflation as measured by Wholesale Price Index (WPI) has been declining both for food and fuel in recent months, declining from 12.4 percent in August 2022 to 10.7 percent in September 2022. The Consumer Price Index (CPI), for food and all-commodities, had remained less than 7 percent, with the exception in the month of September when it reached 7.4 percent, which implies that domestic inflation is around the upper bound of the inflation target.

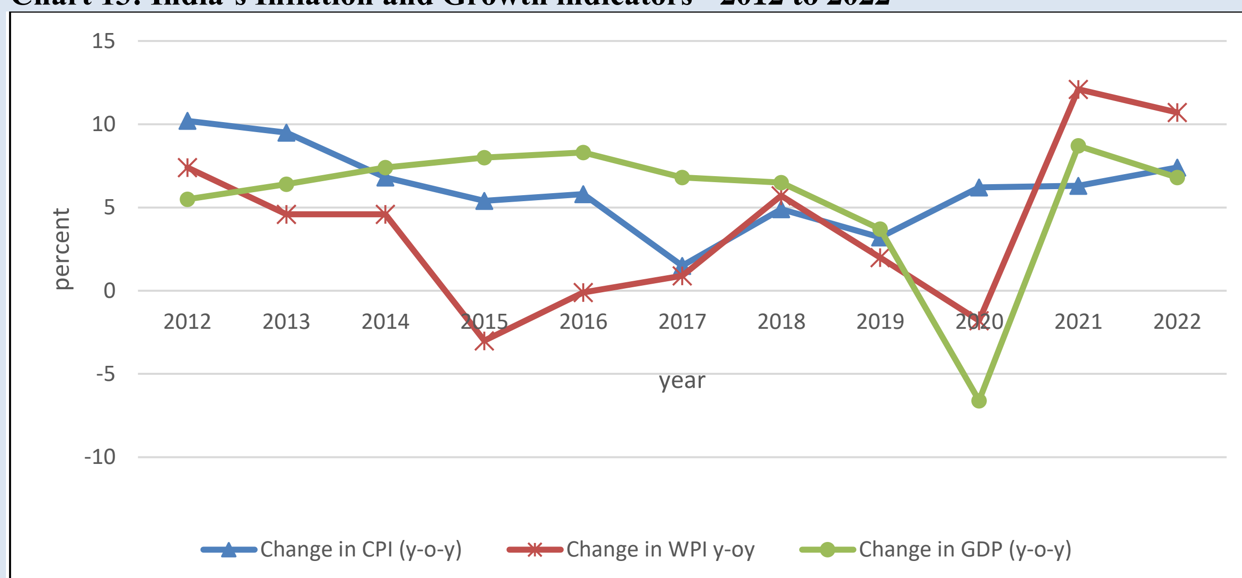
Table 6: Inflation and Growth in India - Decadal Averages

(percent)

	1951-52-1960-61	1961-62-1970-71	1971-72-1980-81	1981-82-1990-91	1991-92-2000-01	2001-02-2010-11	2011-12-2020-21
Inflation- WPI	3.0	6.3	10.3	7.2	7.8	5.6	3.1
GDP Deflator	1.7	6.1	9.0	8.6	8.0	6.4	4.8
GDP Growth Rate	4.0	4.0	3.1	5.6	5.6	6.8	5.1

Source: RBI; IMF, 2022

Chart 13: India's Inflation and Growth indicators - 2012 to 2022



Source: RBI; IMF, 2022

The inflationary pressures in India, as measured with the indices on the upper end of the band, are not due to expansionary monetary policy (as in the US, UK and Euro) or wage price spiral (as in US) or fiscal policy (as in the UK), but temporary because of the rise in commodity prices due to the Russia-Ukraine war. These would be corrected as the war ends. The correction in the prices of crude oil has already begun and that due to food would ease with the new harvest of paddy/wheat in next few months as agriculture is holding robustly with continuous good monsoons. Inflation in the USA and UK are expected to correct in about 2 years because the reasons are embedded in expansionary monetary policy since 2008 and fiscal policy since 2020. Unlike the inflation in AEs, the fact that India's inflation is a product of supply chain

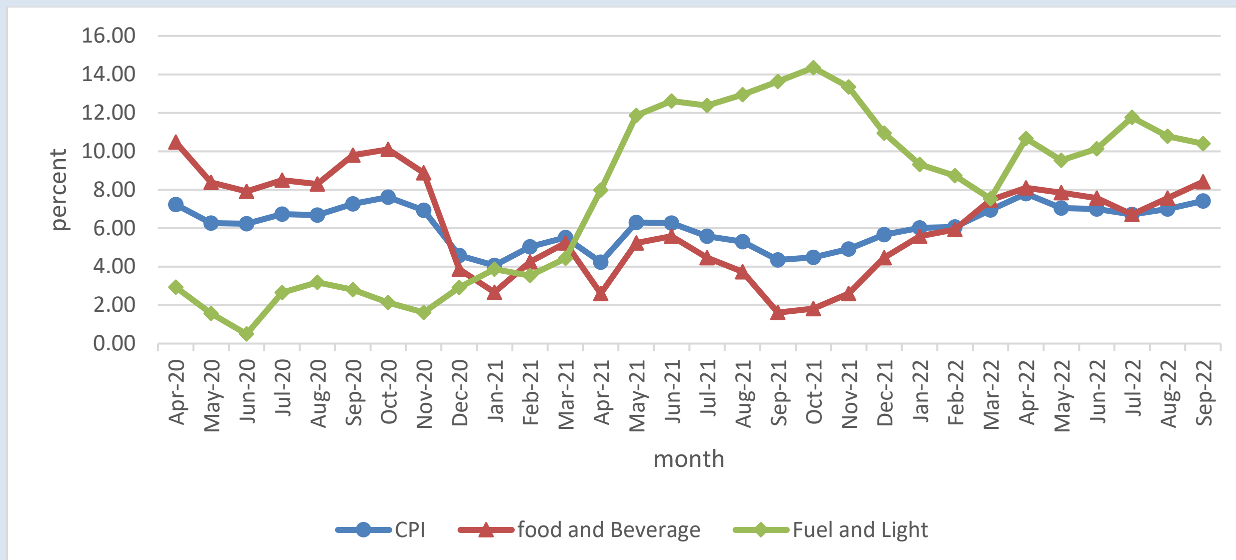
constraints, higher international commodity prices and global macroeconomic headwinds rather than monetary expansion calls for the need to re-examine the suitability of inflation targeting in India.

7: Inflation Targeting Experience in India

In India, till 2015, RBI successfully followed MIA (multiple indicator approach) which covered different aspects of the economy like exchange rates, growth, liquidity conditions in the market and financial stability of institutions, employment and also inflation. In 2016, RBI formally adopted a flexible inflation targeting (IT) framework with price stability as the primary objective and maintaining an operational target of inflation at 4 percent with a band of +/- 2 percent, as measured by the Consumer Price Index (CPI). This approach has come under fire in recent quarters as CPI inflation exceeded the 6 percent benchmark due to restrictions in place in the nation during the pandemic. This raises the question of the adequacy of the IT regime in India and how suitable the conditions are in India for its successful implementation. It is important to consider that in India, it is supply side constraints that majorly contribute to inflationary pressures, especially in food items and fuel. Together, food and fuel constitute 62.1 percent weight in Consumer Prices Index (CPI-Rural), 41.9 percent within CPI-Urban, and 52.7 percent weight CPI-Combined.[7] Food prices in India are a function of factors such as monsoons, Minimum Support Price (MSP), cropping pattern for the year while fuel prices depend majorly on international crude prices and economic certainty. For instance, food component of CPI inflation climbed by 8.4 percent for the month of September 2022, on account of uneven rainfall and supply chain bottle-necks, whereas fuel inflation spiked by 10.3 y-o-y percent in the same month due to global oil production cuts and the Russia-Ukraine war (Chart 14). Partly due to these factors, the CPI inflation rose by 7.4 percent, y-o-y, in September 2022. The IT approach has less efficacy in tackling such inflation.

[7] Ministry of Statistics and Program Implementation, GoI https://pib.gov.in/PressReleasePage.aspx?PRID=1867095

Chart 14: Close relation in the movement of CPI (Combined), food and beverage, and fuel inflation



Source: Database on Indian Economy, RBI, 2022

There is also a need to consider demographic aspects in the context of debate on inflation. Studies had argued for the need to account for differing qualities of populations in economic modelling, since an ageing population and a young population behave differently, which have an invariable impact on demand, consumption, savings and investment patterns. Given that India has 93.2 percent of its population below 64 years of age, as compared to developed nations such as United Kingdom or New Zealand (71.1 percent and 73.2 percent,[8] respectively), Indian policy should be equally focused on job creation and economic growth along with price stability. There has always been a trade-off between employment and growth in India. A moderate level of inflation in any economy is considered healthy as it signifies economic growth driven by growing demand which induces higher production and that in India, the threshold level for inflation is around 6 percent[9]. Therefore 4 percent IT may not be suitable for India. If inflation is lower than the threshold level, then potential output growth cannot be achieved.

The lack of sophisticated econometric models, at least in public domain, and non-availability of reliable data for obtaining these forecasts on series like gross domestic product, inflation rates and employment in India is another main issue. For instance, the RBI had underestimated retail inflation from the actual inflation numbers in the last fourteen quarters, before which it

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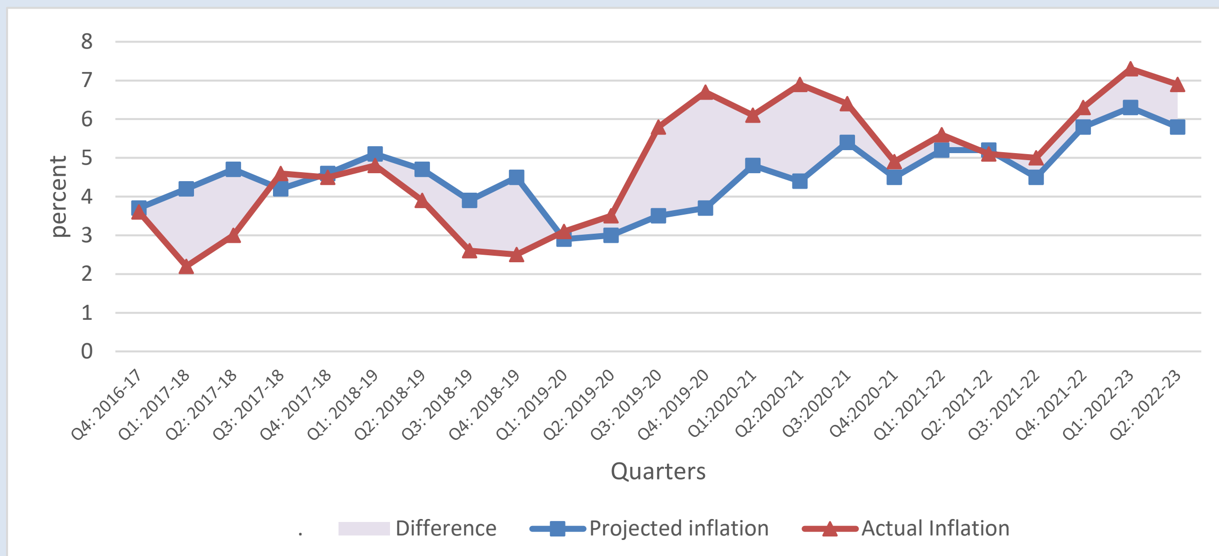
[8] World Development Indicators, World Bank

[9] For economy to have targeted levels of fiscal deficit, current account deficit, and economic growth

had actually overestimated inflation on several instances (Chart 15). While it is understandable to have differences in forecasts and actual results, it tends to create uncertainty in markets, defeating one of the major objectives of introducing IT in the first place, i.e., promoting certainty in policy rates.

Chart 15: Divergence in Actual and Projected inflation by the RBI



Source: Various issues of Monetary Policy Report, RBI

Other criticisms point to the fact that MIA had a much broader scope while the IT regime imposes a narrow focus only on inflation, thereby absolving the central bank of larger responsibilities in diagnosing the problems afflicting the economy. Therefore, there is a need for an analysis of what are the potential pitfalls and the challenges facing this new regime, and what can be done to address these. This includes determining the diverse sources of inflation, prioritising higher employment and growth, undertaking extensive behavioural studies on tolerance levels of inflation, and so on. Also, in view of the large unemployment among the youth, demographic dividend in the country is not being appropriately used and as employment brings in responsibility, obligation and sense of belonging in any employee, higher employment is not only helpful in growth but also ensures that social unrest is minimised.

8: Conclusion

Globally, the aggressive increase in the interest rates by the central banks against the background of rising prices and pandemic-induced economic disruption could lead to concerns about financial stability. India is expected to be the engine of growth for the world economy in the next few years, given good management of fiscal and monetary policy, reflecting high growth and inflation close to its target. AEs, through their reckless expansion in central bank balance sheets and untargeted fiscal stimulus, have faltered in effective and timely regulation of inflation and fiscal management, and have now resorted to aggressive tightening cycles that could entail detrimental results for the global economy, particularly for EMEs like India. By sharply raising the interest rates to tackle inflation, AEs are engineering a recession which could disrupt banking and credit growth, and therefore, they need to play a more responsible global role and take accountability for their past action/inaction.

The RBI need not imitate the AEs or succumb to the temptation of narrowing interest rate differentials, as it is seen that the Indian economy is already performing well in terms of various parameters, and further rise in policy interest rate will hamper the nascent recovery in India, as housing and business investment will suffer. The rich countries are engineering a recession because they can afford high unemployment rates through allowances. The foreign investment comes to India not because of the interest rate differential, but for the strong fundamentals and growth potential. The rise in policy rate will negate the hard work put in the past by the RBI and the government is calibrating a balanced/measured stimulus which is not too restrictive nor aimed at flooding the markets. The robust results are out there seeking celebration. It is more important to prioritise issues like growth and employment rather than narrowing attention to inflation- since it is already clear that bringing down inflation below its threshold limits shall also prove to be detrimental to sustainable growth in the long run.

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