

Inflation Vs Growth : The Tightrope Walk

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Every country in the world has distinguished economic policy, which may vary even though the fundamental concepts remain the same. In the aftermath of balance of payment crisis in 1991 in India, several drastic changes were formulated in Monetary Policy viz. changes in the CRR, SLR, PLR Rates, interest rate deregulation across various segments were initiated. Trade liberalization, financial liberalization, tax reforms and opening up to foreign investments were some of the important steps, which helped Indian economy to gain momentum. With positive indicators such as a stable annual growth rate, rising foreign exchange reserves, a booming capital market and rapidly expanding foreign direct investment (FDI) inflows, India emerged as the second fastest growing major economy in the world.

But along with these success stories, major concern before policy makers has been continuously raising inflation especially since March 2008, which has to be kept under control. Inflation refers a general increase in the prices measured against a general level of purchasing power. Inflation is undesirable because it adversely affects some sections of the population especially the poor, distorts relative prices, leads to an appreciation of real exchange rates, erodes the value of the financial assets and creates instability. Inflation is one of the most regressive and punitive taxes as it reduces the purchasing power particularly of those who are least able to resist it or bear its effects. Through several past incidents, economists have learned that an economy can never be totally free of inflation. In the following paragraphs, we would try and understand a few theoretical as well as practical facets of Monetary policy and its impact on inflation and growth

MONETARY POLICY: AN OVERVIEW

The two major macroeconomic instruments are fiscal policy and monetary policy. These policies affect the performance of economy as a whole. While fiscal policy is concerned with government expenditure and taxes, the monetary policy determines the rate of growth of the nation's money supply which is regulated by central bank of that country.

By monetary policy we mean the regulation of the money supply and the control of the cost and availability of credit by the central bank of the country through the use of deliberate and discretionary actions for achieving the objectives of general economic policy.¹

Monetary Policy deals with changes in money supply, the level & structure of interest rates &

other conditions affecting the level of credit. The fundamental objective of monetary policy is to drive the economy to achieve full-employment with a non-inflationary level of total output.

There are two sides to the monetary policy: With the expansionary monetary policy, central bank decreases rate of interest to increase the supply of money mostly during recessionary situation or during phases of Liquidity crunch in economy. With the contractionary monetary policy decrease in money supply and increase in interest rates are used to correct inflationary situation in order to keep a check on consumption expenditure as well as investment expenditure.²

KEYNESIAN MONETARY POLICY TRANSMISSION MECHANISM:

The monetary transmission mechanism explains how monetary policy changes through changes in nominal interest rates effects various real variables like output and employment.

Changes in the Money supply —————> Changes in interest rates —————> Change in investment —————> Multiple change in income

When interest rate increases, both investment and consumption demand declines, (including both business investment in fixed capital and household investment in consumers durables) which leads to multiple changes in income through multiplier effect. Thus via interest rates hike RBI can check the demand pull inflation in the country by contracting the money supply in the economy.³

The International Monetary Fund has urged the RBI to maintain a tight monetary policy and keep raising interest rate to tame inflation. The inflation situation in the economy continues to be a cause for concern. Despite large scale tightening of the monetary policy by the RBI and other steps taken by the government, inflation continues to remain close to the double digit mark. In June 2011, WPI based headline inflation stood at 9.4 percent. Near term outlook for inflation is not too encouraging and there are chances that we may see inflation jump to the double digit territory on a few occasions. High international oil prices, likely decontrol of diesel prices, surging global food prices and hike in Minimum Support Prices for the upcoming agriculture season are some of the factors that constitute the upside risks to inflation.⁴

In this context, the most fervently discussed topic today has been the most recent interest rate hike (the 11 consecutive one since the last 18 months) made by the RBI. The markets had duly factored in another rise of 25 basis points, but Mr. Subbarao had to surprise them with a rise of 50 basis points. What's more, the Government and economic experts have reinforced the opinion that inflation is the greater evil and needs an immediate firefighting than the well placed fears of an impending economic slowdown.

Industry (i.e. the most affected sectors), as expected is not in a mood to swallow the bitter pill, yet again. Given the IIP growth and the international debt crisis, another painful passage through recession is in the offing. Yet, why is it that the RBI is relentless in its quest for making the money dearer?

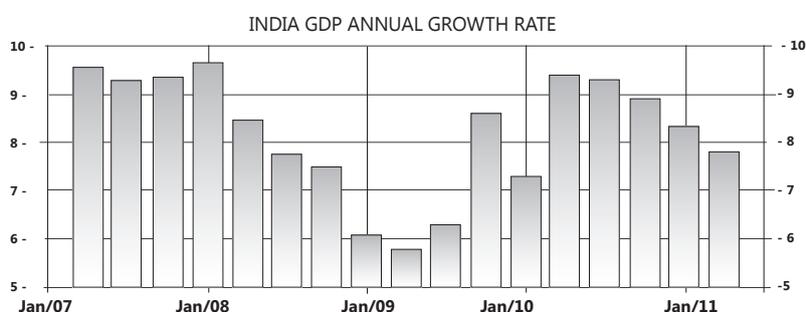
To pull back the inflation is a rare coincidence for a national issue to be at the forefront of both the economic as well as the political agenda. For, inflation has the potential to disrupt stability, both economic and political. Growth with stability seems to one objective accepted universally by all

central banks. The exact policy measures at any given point of time are governed by the exigencies of the situation with an eye on their medium/long run impact.

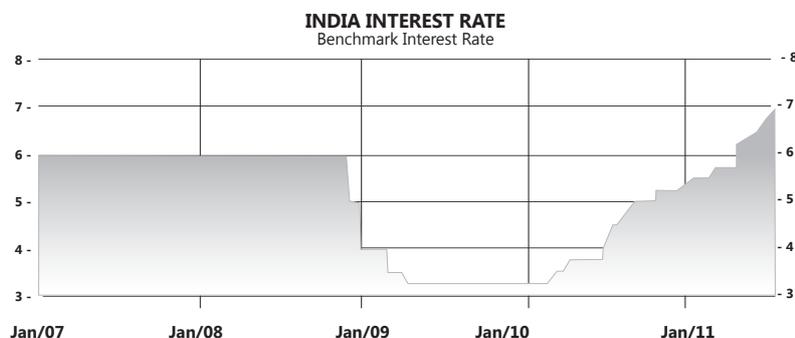
Many of the Central Banks from the developed world follow a policy of what is known as "Inflation Targeting", which implies that the Central Bank determines an inflation rate which it reckons as desirable and then uses one of more of the weapons in its armory namely interest rate, CRR, SLR norms, Quantitative controls etc to achieve it. Life is thus much easier for the developed world as they can focus on inflation alone assuming that there is no such thing as the growth-inflation trade off in the long run. Indian economy, of course is at stage of evolution, where the RBI faces the two fold task of tracking (and directing) growth and inflation. To make matters more challenging (and interesting) is that each policy measure has to weigh its short run and long run ramifications at the same. (Politicians, one can say are lucky in this respect, as they are not aware of the long run)

Presented below is more of an oversimplification of reality⁵. The three charts presented below:

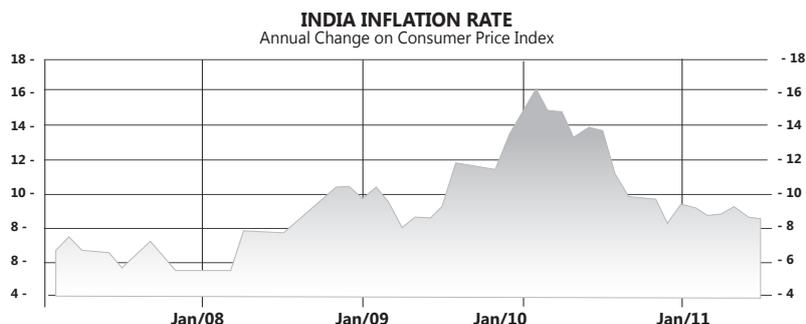
I. Growth rate of GDP



II. Interest Rate (Reverse Repo Rate)



III. Inflation



Phase I Recession to Recovery :

January 2008 to Jan 2009

The period starting Jan 2008 marks the reversal of growth trend following the worldwide recession. The GDP growth declined continuously for the next one and a half years. The GDP rate during this period nosedived (as can be seen from the chart I below) from 9.5% in January 2008 to 5.8% in March 2009. Inflation (measured as CPI), which was comfortable in the beginning at less than 6%, started rising sharply during this period reaching a level as high as 10%. The interest rate (reverse repo rate – rate at which the RBI borrows from banks) was kept constant for some time (as can be seen from chart III) at 6%. The simultaneous fall in growth and sharp increase in inflation would have put the RBI in a stiff position as to what course of action would steady the ship. A contractionary monetary policy (or even keeping the rate of interest constant) would have further dampened the slowing growth rate, whereas an expansionary monetary policy (decrease in the interest rate) could aggravate inflationary pressures.

Phase II : January 2009 to January 2010

The RBI decided to pursue the latter option (following its global peers) and started decreasing the interest rates just before January 2009. As can be seen from chart II, successive rounds of reductions, brought the interest rate level down to 3.25%. This rate was maintained for over a year, during which the economic growth showed signs of recovery. The GDP rate started increasing gradually (emphasizing the inherent 'domestic' strength of the economy relatively less affected from the mayhem in the US and Europe) from around 6% in January 2009 upto 9% by the end of March 2010. However, as might have been anticipated, inflation accelerated continuously, reaching as high as 16% by the end of January 2010. This naturally prompted the RBI to reverse the course of its monetary policy, moving into the contractionary mode. By February 2010, the RBI started stepping up the interest rates to fight inflation.

Phase III: From Recovery to Recession?

With successive interest hikes which have taken place since the last 18 months, the reverse repo rate has reached a 9- year high of 7%. (More importantly, higher than the level we had initially started). To make the situation more complicated (and interesting), the GDP growth rate is gradually tapering off during this phase of rate hikes. So much so , that the GDP target has been revised downwards to 8.2% from the earlier 9%. To make matters worse, the ominous cues from all over the globe portend another double dip recession. We are now in the midst of yet another fluid and uncertain situation, where the RBI is confronted with the ever intriguing dilemma - whether to curb inflation at the cost of growth (or even worse – at the risk of recession) or sustain (or at least attempt to) the growth at higher prices. Faced with a similar situation two and half years back (refer Phase I given above)- slowing growth accompanied with high prices, the RBI had chosen to lower interest rates. As the current scenario is not exactly the same as the earlier one, the RBI has chosen to go the other way. The RBI has recently raised interest rate by 50 basis points, taking the reverse repo rate to 7% and the repo rate to 8%. The verdict is pretty clear – Priority to Inflation control over Growth.

One interesting inference could be that the ongoing inflation is partly fuelled by the expansionary monetary policy pursued some time earlier. So it is all the more imperative that RBI douses the fire

lest it might go out of control.

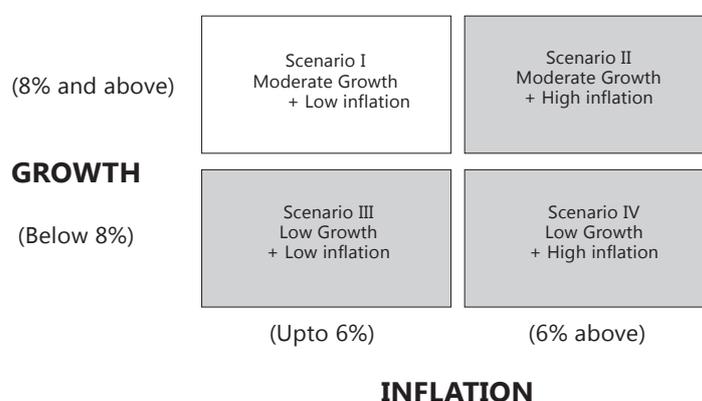
The Way forward

There is always a time lag between a monetary policy move and its impact on the real economy. The successive hikes help in creating a momentum in the desired direction over a period of time, which may eventually rein in inflation. Further, the prevailing negative interest rates (inflation rate being greater than nominal interest rates) negatively impact savings and boost consumption, which keeps prices high. Hence, we are likely to see more interest rate hikes over the next few months. In other words, the policy is likely to be pursued till inflation is well and truly under control (or at least till we see real interest rates turning positive). Anything less than that would largely nullify the efforts made by the RBI so far.

More importantly, the case for continual rate hike is that inflation itself would impede growth and investment in the medium term. Fears of dampening investment climate/growth due to rising interest rates might invoke a fierce response from certain sections of the industry. However, it is to be remembered that inflation could play a bigger spoilsport (even for the industry) in the times to come. This explains the reason why the recent rate hike, despite raising a few eyebrows has been largely welcomed by most of the experts.

Assuming the RBI continues on its rate hike spree, the next question to be asked is “What happens to growth”.

There could be various outcomes of the RBI policy. Some broad scenarios have been outlined in the above diagram in a simplistic manner in the form of a Growth – Inflation matrix



The successful transmission of the current monetary policy would make Scenarios II and IV (i.e inflation continuing to menace the economy) less probable.

Even if the inflation is controlled (as in Scenarios I & III), the level of growth may or may not be sustained based on a number of factors. Scenario I given above is the most desirable one with both targets (inflation less than 6% with growth of 8%) being achieved. This is to drive home the point that Monetary policy alone may not be the solution to the situation.

Though it may hit by the higher rates of interest, Growth is not a function of the monetary policy alone. So is the case with inflation. The foregoing discussion doesn't delve into the impact of

the Fiscal policy, Structural reforms and debottlenecking of the supply side factors, all of which together will also have bearing on growth rate and inflation. By taking on the responsibility to douse inflation, the RBI has implicitly prodded the Government to take prudent and complementary policy measures in order to sustain the growth rate.

Fiscal consolidation, implying a lower fiscal deficit has been on the policy agenda for quite some time. The Fiscal Responsibility & Budgetary Management Act stipulates a target for fiscal deficit of 3 % of GDP. Although the Fiscal deficit has decreased from 6.3% in 2009-10 to 4.7% of GDP in 2010-11, we have been lagging behind. The target for the current year is 4.7% and looks to be a stiff one to achieve if oil prices do not come down. A high fiscal deficit may lead to higher inflation and could make the anti-inflationary monetary policy pursued by the RBI less effective and vice versa. So also, government spending affects both the Investment and the Consumption demand, thus having a direct impact on the growth rate of GDP. The bottom line is that both the Monetary policy and Fiscal policy should act in tandem with each other to be effective.

On the other hand, there are a number of Supply side reforms, which required immediate attention and promise immediate and long lasting benefits. Some of the important supply side factors for agriculture would include (among others) improving farm productivity, fixing of broken agricultural produce distribution system, allowing farmers to strike deals in the open market, circumventing the middlemen, reforming APMC Act etc. Revamping the Public Distribution System would have long term and far reaching benefits for the masses. For the economy as a whole, addressing the infrastructure bottlenecks and human capital imbalances which fuel non-food inflation is important. All these would require a strong political will, co-operation and co-ordination between the Central and State Governments and efficient administrative machinery for their execution.

The Free market economy exposes us to a plethora of challenges and opportunities. Without (and despite) policy interventions the trade cycle may turn into an economic roller coaster! The Government, the Central Bank and the Real economy, together have to drive and at the same time be driven by each other to keep the ball rolling.

Reference

(Endnotes)

- 1 Mishra & Puri, Economic Environment of Business, pp no 182
- 2 Friedman, M. (1968), "The role of monetary policy", American Economic Review, Vol. 58 No. 1, pp. 1-17.
- 3 Dornbusch, R. and Fischer, S. (1994), Macroeconomics, 8th International ed., McGraw-Hill, New York, NY.
- 4 <http://www.rbi.org.in/home>
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