Return of Inflation

This article is based on **"The perils of RBI's fixation on inflation"**, **"A rough patch"**, **"Inflation shocker: On rise of consumer price inflation"**. It talks about the reasons for the current rise in inflation in the Indian Economy.

The consumer price index (CPI) rose to 7.35% in December 2019. This high rate of inflation comes as a twofold setback **for the government,** which is saddled with the **decade's slowest rate of growth at 5%.** This rate of inflation is the highest since 2014, also it crossed the threshold limit (6%) set by the Reserve Bank of India.

This can force the Reserve Bank to maintain status-quo on policy rates, this might lead to the tight monetary policy which in turn can impede the recovery process of Indian Indian economy.

This double whammy of slow growth and high inflation is called stagflation.

What is Inflation?

- Inflation refers to the rise in the prices of most goods and services of daily or common use, such as food, clothing, housing, recreation, transport, consumer staples, etc.
- Inflation measures the average price change in a basket of commodities and services over time.
- The opposite and rare fall in the price index of this basket of items is called 'deflation'.
- Inflation is indicative of the decrease in the purchasing power of a unit of a country's currency. This could ultimately lead to a deceleration in economic growth.
- However, a moderate level of inflation is required in the economy to ensure that production is promoted.

Who measures Inflation in India?

- Inflation is measured by a central government authority, which is in charge of adopting measures to ensure the smooth running of the economy. In India, the **Ministry of Statistics and Programme Implementation** measures inflation.

- In India, inflation is primarily measured by two main indices — WPI (Wholesale Price Index) and CPI (Consumer Price Index) which measure wholesale and retail-level price changes, respectively. The CPI calculates the difference in the price of commodities and services such as food, medical care, education, electronics etc, which Indian consumers buy for use.

What are the main causes of Inflation?

Some key reasons for Inflation:

- High demand and low production or supply of multiple commodities create a **demand-supply gap,** which leads to a hike in prices.
- Excess circulation of money leads to inflation as money loses its purchasing power.
- With people having more money, they also tend to spend more, which causes increased demand.
- Spurt in production prices of certain commodities also causes inflation as the price of the final product increases. This is called **cost-push inflation.**
- Increase in the prices of goods and services is also a factor to consider as the involved labour also expects and demands more costs/wages to maintain their cost of living. This spirals to further increase in the prices of goods.

What is Stagflation?

- The term was coined by **Iain Macleod,** a Conservative Party MP in the United Kingdom, in November 1965.
- Stagflation is said to happen when an **economy faces stagnant growth as well as persistently high inflation.**
- With stalled economic growth, unemployment tends to rise and existing incomes do not rise fast enough and yet, people have to contend with rising inflation.
- So people find themselves pressurised from both sides as their purchasing power is reduced.

Case of Stagflation

- In the early and mid-1970s when OPEC (The Organisation of Petroleum Exporting Countries), which works like a cartel, decided to cut supply and sent oil prices soaring across the world.
- On the one hand, the rise in oil prices constrained the productive capacity of most western economies that heavily depended on oil, thus hampering economic growth. On the other hand, the oil price spike also led to inflation and commodities became more costly.
- For instance, in 1974, the oil prices went up by almost 70% and it leads to a consequent rise in inflation.

Is India facing Stagflation?

Although it appears so at first glance, India is not yet facing stagflation.

- India is not growing as fast as it used to in the past, but India is still growing at 5% and is expected to grow faster in the coming years.
- It is true that retail inflation has been quite high in the past few months, yet the reason for this spike is temporary because it has been caused by a spurt in agricultural commodities after some unseasonal rains.
    - With better food management, food inflation is expected to come down. The core inflation – that is inflation without taking into account food and fuel – is still benign.
- Retail inflation has been well within the RBI's target level of 4% for most of the year. A sudden spike of a few months, which is likely to flatten out in the next few months, it is still early days before one claims that India has stagflation.

Reasons for Current Inflation in India

Food Inflation is a major cause of inflation in India today, the following can be the causes of this:

- **Untimely rains, drought in some regions** and crop losses due to local factors did contribute to supply shocks.
- **Transmission of global food prices,** which have shown a rising trend in the last half-year, also is the reason for food inflation.
- The government policy of **untimely imports in pulses** flooded the markets and contributed to lower price realization last year. This led to lower production of pulses this year.
- The government had procured 34 million tonnes of wheat in 2019, on top of the 36 million tonnes procured in 2018. These are the highest procurement levels since 2012-13. However, it failed to distribute the wheat through the public distribution system. This has created an **artificial scarcity** that has led to Inflation.

Inflation and RBI

- In India, the RBI had earlier pursued a **'multiple indicators approach'** where it has to play the role of control inflation, regulating commercial banks, managing balance payments etc.

- However, with the adoption of the **‘modern monetary policy framework 2016-17**, **inflation targeting** was set as the sole objective of monetary policy of RBI.
    - The RBI was permitted to exceed or fall short of a targeted inflation rate of 4% by a margin of 2 percentage points.
    - RBI is mandated to solely focus on inflation, but this may have led to the neglect of the regulatory function of RBI on financial institutions.
    - The crisis in the financial sector has created a cycle of low profits-low saving rate-low investment rate. This has resulted in a slowdown in the economy. Moreover, even the target of inflation is not met.
- Therefore, the central bank’s shift of focus from financial stability to inflation targeting could have led to **regulatory infirmity. For example**
    - In 2018, within three years of the adoption of inflation targeting goal, a **crisis engulfed IL&FS,** a non-banking financial company in the infrastructure space.
    - It defaulted on several of its obligations, including repayment of bank loans and the redemption of commercial paper.
    - The IL&FS was not just another ‘shadow bank’; it operated over 100 subsidiaries and was sitting on a debt of ₹94,000 crores.

Conclusion

With food accounting for **two-thirds of household budgets,** higher prices will worsen demand for non-food goods. At a time when consumption expenditure data shows rising poverty along with declining wages, climbing inflation will only lead to increased vulnerability, while making an economic recovery harder.

In this context, RBI’s sole mandate of inflation targeting requires a relook and in the broader scheme of things, there is a need for synchronization of the fiscal policy with monetary policy. This may help the government to avert the condition of stagflation before it has a detrimental impact on Indian Economy.

Drishti Mains Question

India needs to move beyond the inflation targeting in its monetary policy.
Discuss.