Inflation is high because of changing macro realities, widening inequality

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Each of these macro-trends has contributed towards high inflation in India

Deepanshu Mohan,

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Credit: Reuters Photo

Two of the world's leading economists, Ben Bernanke, who recently won a Nobel in Economics, and Olivier Blanchard, an ex-IMF chief economist, have recently published a study together explaining the reasons for the surge in inflation seen across the US since 2021.

For two years, a debate has been brewing amongst economists and policy wonks all over on what has caused the highest inflation rate seen in the US since the 1980s, which simultaneously created exogenous (or external) conditions for price surges in other parts of the world, too: was it triggered by the generous government stimulus or due to pandemic-related (supply-side) disruptions?

Bernanke and Blanchard respond to this question by saying that the answer includes both: stimulus released by the federal government and the supply side disruptions that resulted in a price rise for consumer goods.

But, what about the Indian case?

This author wrote in early 2021, at a time when inflation rate wasn't that particularly high in India, that a longer inflationary spiral may grip the economy, which won't be explained by temporary (external) factors alone.

Looking at the numbers over a longer period of time, we can safely say now that this observation has been vindicated, despite what government economists were arguing at the time.

Yet, a question that is critical to ask, and assess, is: what made the inflation rate in India remain persistently high despite many 'usual' drivers of inflation (demand pull or cost-push effects) being relatively marginal in scope, compared to drivers of inflation (as analysed by Bernanke-Blanchard) in more industrially advanced nations such as the US, the UK and the EU?

The answer to this can be explained in five critical factors summated as observations here that contributed and sustained higher inflation in India:

1.High M1 (money supply) contributing to inflation: If you see the trend clearly here, M1 — which as a component of money supply is composed of all liquifiable assets (currency, demand deposits, other liquid deposits, including savings deposits) — has been rising since 2020, allowing inflation levels to pick up over time.

It's only in the last few months that there has been a growing divergence in trend between a rising M1 and the underlying inflation numbers (which makes other factors more important to study below).

2.High bank loan-credit growth: Up until 2022, there was less of a direct link between what was happening on bank loans, the credit growth side and inflation. Generally, bank loans and credit growth levels have remained low over the last few years (prior to the pandemic) but this trend changed in 2022.

A credit-fuelled spending pattern amongst the organised, banking class of urban citizenry, which is also borrowing more now, contributed towards pushing inflation, jacking up the prices of essential consumer goods, from food to everything else. Over the last year, as we have seen a rise in interest rates (or an increased cost of borrowing), which is slowing down the bank-loan growth rate (or making borrowing more costly), this is helping reduce the inflation rate from the use of monetary policy (bringing M1 down and contracting borrowing).

3. High imports (including for non-fuel/gasoline imports) and import prices: This trend connection is vital in understanding India's more recent inflationary spiral. With consumer income data made available recently, over the last five years (2016-2021), particularly during the pandemic, an increased income (household per-capita income) rise seen amongst the richest 20 per cent and the upper middle 20 per cent resulted in a drastic shift in consumption patterns and preferences. More imports of goods and services are being consumed by these classes, given how their willingness to pay/consume has gone up with higher income, even though the poorest 20 per cent, middle-income 20 per cent, and lower middle-income 20 per cent have seen negative income growth.

It must also be highlighted how rising imports are not of 'fuel' alone, though POL/fuel imports in volume still occupy the largest import basket for the Indian economy.

The Indian private and government oil business has in fact utilised 'cheaper' oil discounts from Russia to increase their imports of fuel over the last few months and process these to be exported in the EU. None of the 'positive' spillover effect of importing this 'cheaper' oil has effectively been passed onto the Indian consumer (as one can see how retail oil prices have continued to remain high despite the lower import bill on fuel).

4. Low domestic productivity and growth shifting 'richer' consumption groups to increase their 'import-based dependence' have caused inflation to rise: Taking cue from point (3) above, a lower GDP growth level plus a lower domestic productivity level has made 'richer' income growing classes to increase their consumption of goods/services via imports, which for GST revenue proceeds might be good news. But this has contributed directly to inflation and two other macro issues: a widening current account deficit (imports being significantly higher than exports) and a poorer growth trajectory for the Indian economy as a whole, giving rise to stagflationary concerns on account of a higher unemployment-underemployment level seen along with a high inflation rate.

5. 'Greed-flation' amongst the richer corporate class that saw soaring profits during the pandemic years (you see a direct correlative effect between inflation rise and per unit profit rise amongst these firms) has contributed to inflation. This is a trend in India, where a select group of firms remained hyper-profitable during the pandemic, and consistent with what has been seen in the US, the UK, the EU and other countries. Scholars like Isabella M. Weber have explained this in more detail through their work arguing how 'greed-flation' is real and has contributed to inflation world over.

Each of these macro-trends has contributed towards high inflation in India. Widening economic inequality and a rising consumerism for 'imports' amidst a low growth-investment cycle domestically have made policy interventions at a national level even more challenging, which will make the usual policy tools of correcting for inflation (via monetary policy) even less effective in the future, as has been observed in the recent past.

(The writer is Director, Centre for New Economics Studies, Jindal Global University, and co-author of the book ‘Strongmen Saviours -- A Political Economy of Populism in India, Turkey, Russia and Brazil)