If India aims to contain inflation, it can’t rely on the standard monetary policy toolkit

A singular, disentangled macro-approach may push the economy into a deeper recessionary space.

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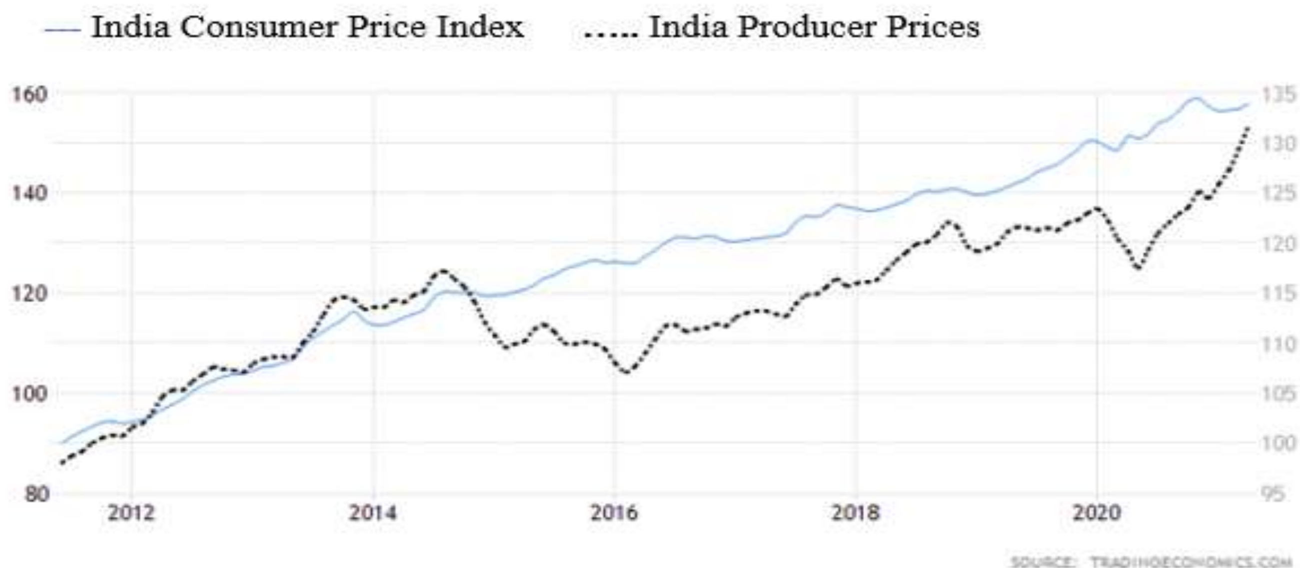
A vegetable vendor in Chennai in April 2020. | Arun Sankar/AFP

Recent numbers on inflation, as part of a global trend rise in prices of commodities, food and fuel, paint a worrying picture for the Indian economy. At a time of a deep crisis fuelled by uncertain economic expectations, a pandemic wave in rural India, 97% households recently reported no rise in their real incomes from last year.

Consumption demand has already been low along with domestic private investment demand, and unemployment levels are increasing with a steeping curve of inflation, as reported from the Wholesale Price Index numbers.

A combination of these trends in a low- or no-growth cycle makes matters interminably worse for any large emerging economy like India.



When a slow cycle of global economic recovery starts, as it is underway in most developed markets where vaccinated populations are relatively high, a temporal rise in inflation is bound to occur. In India, we see this trend at a time when only less than 3.5% of its population is fully vaccinated.

A rise in inflation right now will happen as each economic agent (say, a firm or a household) in an economy is likely to act on her own device to decide what, where, and how much to spend, without taking into consideration whether a given product or service is available in sufficient supply.

In the current context, however, amidst a pandemic-induced uncertainty, the basic principles used in designing a macro-understanding of inflationary expectations might be difficult to apply. What is needed: a worm's eye, anthropological description of price rise from a localised perspective to help design effective policy solutions.

Getting a haircut

After weeks of lockdown, if most want to get a haircut from a saloon, the price of getting that haircut would depend on how many saloon owners have opened their shop up-and how many barbers they employed are back in the shop to offer their services. None of these factors work in tandem, as one may expect.

It may now take time for saloon owners to open up while ensuring Covid protocols are in place for consumers to feel safe, they would operate on low capacity (taking fewer appointments). Many barbers or hair stylists may be reluctant to work When a slow cycle of global economic recovery starts, as it is underway in most developed markets where vaccinated populations are relatively high, a temporal rise in inflation is bound to happen. In India, we see this trend at a time when only less than 3.5% of its population is fully vaccinated.

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It may take time for saloon owners to open up while ensuring Covid protocols are in place for consumers to feel safe. They would operate on low capacity (taking fewer appointments). Many barbers may be reluctant to work or demand higher wages for the risk of exposure to getting infected before coming back to work. Any of these factors may push up the prices of a haircut (or other saloon services).

Getting back to normal

Similarly, in an informal space, if a chaiwallah operating near a construction work site location in Delhi, sees a huge surge in demand for tea after unlocking allows for construction activity to resume, he would immediately need a greater quantity of milk procured for tea – say from his regular distributor who travels from rural Haryana where milk is produced.

Given this milk distributor is from the neighboring state where lockdown restrictions on mobility are still in place (or perhaps different to those in Delhi), supplies of milk may be stalled or delayed depending on the changing restrictions in place. What happens? The price of tea goes up.

At the same time, a daily-wage worker employed at the construction site, who may have joined back at a lower wage (or the same wage as before), now finds her purchasing power diminished. So far, India's Consumer Price Index data does not reflect a very high food inflationary trend but it is likely to in coming weeks.

An interplay of these localised factors coalesced with a high degree of uncertainty on the lives and livelihoods of economic agents because of the impact of the virus will cause inflation and the both Consumer Price index) and the Wholesale Price Index levels to rise. It is extremely difficult to have a given policy prescription, or a formulaic approach designed to address this kind of rise in inflationary expectations or in actual prices.

The Reserve Bank of India, announcing its next quarterly monetary policy review on Friday, ended doing very little to address the situation, keeping rates of the monetary policy toolkit at the same level. Why? The RBI, and most other central banks of emerging economies, find themselves right now in a helpless situation to address their core objective of inflation targeting, when the factors aiding rise of inflation are less explained by causal binary reasons of demand-pull and/or cost-push inflation alone at a macro level.

Newer behavioral causes from a pandemic-driven anxiety and rising uncertainty amongst consumer and low capital producers accentuates the need to use a greater entwinement of both fiscal-monetary support, in allowing consumer and producer sentiment to improve. This is key in getting India's economy out of the Keynesian tailspin it is in in (and one that was afflicting us way before the pandemic).

Household cash transfers

Fiscal support right now requires the government to provide more direct income support'and that too in form of unconditional transfers to households, giving them the opportunity to spend, spend and spend. That is what is going to subsequently drive both private investment demand and employment levels over time. Even any form of targeted transfer support programmes – say for a particular economic group – may not be entirely effective.

Unconditional cash support would offer all households a discretionary choice to spend money the way they want, and on what they want. The government cannot make those decisions for any economic agent nor presume to claim that they know their presumptive will. So, any substitutive support provided in form of rations, food stamps or other kind-based transfers alone will not help.

Even an increased allocations for the Mahatma Gandhi National Rural Employment Guarantee Scheme to give members of households 100 days of work a year, as important as it may be, will pay only those who work with the underlying assumption that there is work in those areas.

At a time when infections are rising in rural areas of many affected states like UP, Bihar, MGNREGA work there may hardly happening (or people may just be too afraid to get out of homes and work). In other words, even conditional cash-based transfers may be less effective for their intended purpose in such states when a pandemic is still surging.

Localised fiscal interventions would need to be designed accordingly to support monetary policy thinking. A one-size-fits-all fiscal/monetary solution would not address the structural concerns at play.

The other problem is concerned with how most central banks still tend to function under the operative and functional framework, shadowing the work of economist Milton Friedman. We are already seeing evidence of how the design of monetary policy and projected central bank autonomy –away from the contours of fiscal policy – is becoming an institutionalised myth across nations. Economic historian Robert Skidelsky brings this fact out in much detail in one of his columns here, when he says: "Reluctance to admit the relevance of Keynesian theory over monetarism has warped the language of macroeconomic policy."

In India's context too, the recent quantitative easing of liquidity restrictions came largely in response to the pandemic-induced economic crisis impact, which was nothing but a veiled attempt by the government to substitute monetary ease for any form of direct fiscal intervention. It is difficult to conceive if this would have been the case had 2020-'21 or 2021-'22 would have been a national election year.

What we saw ultimately was the ineffectiveness of supply-side monetary policy. Most micro, small and medium firms, that received much of the credit-ease in monetary policy announcements last year remain debt-clogged and less willing to invest in new capacity.

Therefore, going forward, the key, in conceiving a comprehensive response to the rising inflationary tensions – when all other macroeconomic aggregates show red signs of trouble and uncertainty regarding the future is high – is to pursue a localised, counter-cyclical, fiscal-monetary complimentary approach combining both, instruments of direct government support, along with ease

in liquidity and bank-credit restrictions (via reductions in cost of borrowing) in making economic agents to become free to choose.

A singular, disentangled macro-approach addressing any temporal rise in inflation or supply side disruptions – through a monetary policy toolkit – may further drive other aggregates (consumption demand, private investment demand) into a deeper recessionary space.

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