Diagnosing India's Inflationary Signals Right

The pandemic complications will require a strong response that will necessarily involve a multi-faceted approach.

A healthcare worker checks the temperature of a rice mill worker during a coronavirus disease (COVID-19) vaccination drive at Bavla village on the outskirts of Ahmedabad, India, April 13, 2021. Photo: Reuters/Amit Dave/File Photo

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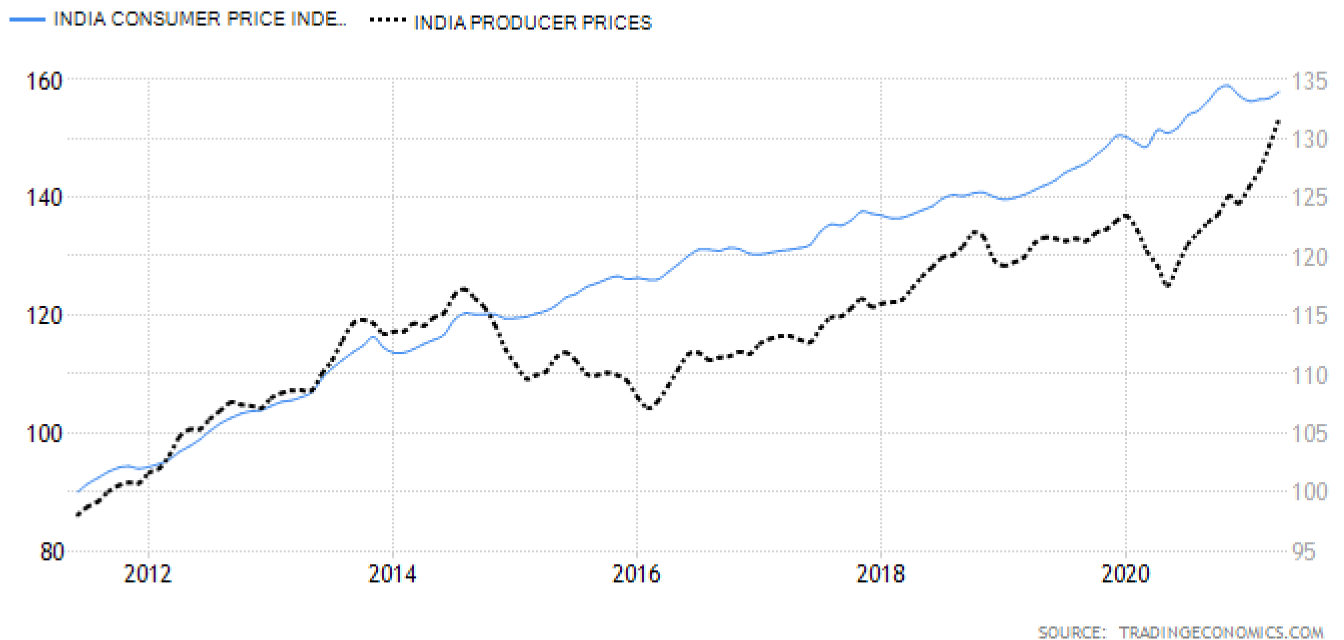
Recent numbers on inflation – as part of a global trend in rise in prices of commodities, food and fuel – paint a nuanced picture for the Indian economy as a whole.

At a time of deep crisis fuelled by 'uncertain' economic expectations and a surging 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 (WPI) 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 happen. In India, we see this trend at a time when only less than 3.5% of its population is fully vaccinated.

A temporal rise in inflation happens as each economic agent (say, a firm or a household) in an economy tends acts on her own device and decides what, where, and how much to spend, without taking into consideration whether a given product or service is available in sufficient supply.

After weeks of lockdown in place, 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 – 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-19 protocols’ are in place for consumers to feel safe. They would operate on low capacity (taking lesser appointments), and most barbers (or hair stylists) may be reluctant to work – or may demand higher wages, for the risk of exposure to getting infected – before coming back to work. Any of these factors may push the prices of a haircut (or other saloon services) up.

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 in the capital, he would immediately need greater quantity of milk procured for tea – say from his regular distributor who travels from rural Haryana where production of milk happens.

Given this ‘milk distributor’ is from the neighbouring state where ‘lockdown’ restrictions on mobility are still in place (or maybe different to those in Delhi), supplies

of milk may be stalled or delayed depending on the changing restrictions in place. What happens? 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 CPI data does not reflect a very high food inflationary trend but it is likely to in coming weeks or months.

Daily wage labourers and homeless people wait to receive free food during an extended nationwide lockdown to slow the spread of the coronavirus disease (COVID-19) in New Delhi, India, April 28, 2020. Photo: Reuters/Danish Siddiqui/Files

An interplay of these localised factors coalesced with the high degree of uncertainty present because of the impact of the virus (still surging in rural India) on the lives and livelihoods of economic agents will cause 'inflation', at both CPI and WPI levels to temporarily rise. And 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 central bank, which is due to announce its next quarterly monetary policy review in the next few days, may end up doing very little-keeping most of the rates and tools at the same level, to address this situation at hand. The RBI, and most other central banks of emerging economies, find themselves in a helpless situation to address their core objective of 'inflation targeting', when the factors aiding the rise of inflation are less explained by the binary reasons of 'demand-pull' and/or 'cost-push' inflation alone (relevant for normal times).

The 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-sentiments to improve, which is key in getting India's economy out of the '*Keynesian tailspin*' we are in (and one that was afflicting us way before the pandemic).

Fiscal support 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. Any form of targeted transfer or support programme may not work now.

Unconditional cash support offers all households a choice to spend money the way they want, and on what they want. The government can't 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 'ration', 'food stamps', or other kind-based transfers alone, won't help.

Labourers at an MGNREGA construction site in Navsari. Photo: PTI/File

Even an increased allocation for MGNREGA in rural areas, 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 Uttar Pradesh and Bihar, MGNREGA work there may hardly happen (or people may just be too afraid to get out of homes and work). In other words, even 'conditional cash-based transfers' may work less for their intended purpose in such states. Localised fiscal interventions would therefore need to be designed accordingly to support monetary policy thinking. A one-size-fits-all (fiscal/monetary) solution won't 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 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.

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 MSME 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.

The key, therefore, 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 that combines both instruments of direct government support along with an ease in liquidity and bank-credit restrictions (via reductions in cost of borrowing).

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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