Rajan's Target: Inflation or the poor?

Rohit

Raghuram Rajan, the incumbent Governor of the RBI, has recently announced that the Indian Parliament should set inflation targets for the RBI to follow. On the face of it, it looks like the RBI is trying to hold itself accountable to the elected representatives of the people especially in the interest of the poor. But is it really so?

Targets have become rule of the day with the Fiscal Responsibility Budgetary Management (FRBM) Act taking the lead on the fiscal front and now Inflation Targeting (IT) on the monetary front. A lot has been written about the FRBM from opposite perspectives but policy of inflation targeting in India seems to be a more recent phenomenon. Therefore, let's look at that.

India has been witnessing significantly high rates for inflation since mid-2009 and, except for some blips here and there, it has continued to remain quite high. This obviously hurts those whose income is not indexed to inflation. Now there are broadly two category of people who are hurt by this the most, the obvious ones i.e. the poor and not so obvious ones, those invested in financial assets (in particular large international players), whose real value depreciates with inflation.

The way the policy of inflation targeting works is that it is assumed that there is a trade-off between inflation and the level of output, so to bring the inflation down, one needs to bring the level of output (thereby the level of employment) down. This could be done by targeting a higher rate of interest, which affects two of the most important components of total output, private investment and credit financed consumption, adversely.

On the face of it, the policy stance looks just fine. But there is many a slip between the cup and the lip, in particular, if the underlying assumption of trade-off between output and inflation turns out to be incorrect. Output is normally assumed to be positively related to inflation because the per-unit cost of production is assumed to be increasing in output. This can happen for a variety of reasons: strength of the labour unions rise with increase in employment which pushes up their wage demands; productivity of inputs like labour decreases with increased usage (in the jargon of economics, there is diminishing marginal productivity of labour); supply constraints of other inputs pushes their prices up. So, any cutting down of production would bring the costs of these factors down and, thereby, the inflation. But what if these reasons are economically unsound or unreasonable for a developing country like ours?

For a developing economy like India with a vast reserve army of labour (reflected in a burgeoning unorganised sector), assuming an increasing bargaining strength of the working class with higher employment seems so distanced from reality. Moreover, if usage of all inputs is rising in tandem, there is no reason why an additional unit of output will cost more than the previous unit. Therefore, there hardly seems to be a direct relationship between output and inflation.

Given this, any policy to control inflation by targeting a lower level of output will be counterproductive. It will not only fail to control inflation but it will increase unemployment and bring in the fears of a recession which could fuel such pessimistic expectations even further. That this has been witnessed by India in the last 2-3 years should not come as a surprise. While the Index of Industrial Production (IIP) has seen a declining trend over the period of continual hike in the rates of the interests, inflation has hardly abated except in situations where monsoon played a supportive role.

This brings us to the question of why inflation has been so stubborn over the last few years. The answer to this question lies in looking at the cost side rather than the demand side of it. Kalecki, a Marxist economist, had proposed that while prices of industrial commodities are cost-determined, that of the primary commodities is demand-determined. Indeed, can one say that the prices of automobile increase just because there has been a surge in its demand? On the other hand, it can be true for agricultural commodities. So, it is obvious that inflation entering into the system from the latter can't be controlled by bringing the production of the former down. Moreover, inflation through critical inputs coming from abroad (because of the increase in dollar prices and/or depreciation of the Rupee), like oil, also cannot be controlled by bringing the production and employment down. For primary commodities, inflation essentially follows from: inadequate and volatile production; speculative hoarding, commodities futures.

What the government needs to do is to attack at the real source of inflation like the ones mentioned above. It could do the following: (a) use countercyclical taxation on oil and related items (increase tax rates when their prices in rupee terms are low and vice versa); (b) improve and invest hugely in storage capacities across the country; (c) bring back the policies of minimum support prices on major food items to avoid the volatility in their prices; (d) control the futures market; (e) crackdown and punitive action against commodity hoarders.

The immediate question that arises is if the current policy of inflation targeting is flawed and imposes misery on the working people of the country without any significant impact on inflation, why is the government not willing to change its strategy and move in favour of some of the steps mentioned above? The answer to this question is more political than economic. Once you have charted out a path of economic 'reforms' aimed at attracting international finance, the real returns for which run opposite to inflation, it is obvious that you have to keep or at least seen to be endeavouring to have low inflation rates. Moreover, greater the dependence of the economy on international finance, greater will be the need for such and other policy measures to make it a more attractive destination.

*** A version of this article was published in the Anandabazar Patrika, Kolkata**