



Has India Successfully Tamed the Inflation Dragon?

(This editorial is based on the article “Has India successfully tamed the inflation dragon?” which appeared in Livemint for 13th February 2019.)

Has India finally succeeded in taming the inflation dragon?

The answer has profound consequences for Indian macroeconomics. It is well known that headline inflation in India has nearly halved over the past five years. The most recent readings have been well below the central point of the target range given to the Reserve Bank of India by the government.

What is Inflation?

- Inflation is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over a period of time.
- Often expressed as a percentage, inflation indicates a decrease in the purchasing power of a nation's currency.
- As prices rise, they start to impact the general cost of living for the common public and the appropriate monetary authority of the country, like the central bank, then takes the necessary measures to keep inflation within permissible limits and keep the economy running smoothly.

Types of Inflation

- **Demand-Pull Inflation:** This represents a situation where the basic factor at work is the increase in aggregate demand for output either from households or entrepreneurs or the government. The result is that the pressure of demand is such that it cannot be met by the currently available supply of output.
- **Cost-Push Inflation:** We can visualize situations where even though there is no increase in aggregate demand, prices may still rise. This may happen if there is an initial increase in costs independent of any increase in aggregate demand.
- According to **structural theory of inflation**, market power is one of the factors that cause inflation, but it is not the only factor. The supporters of structural theories believed that inflation arises due to structural maladjustments in the country or due to some of the institutional features of its business environment.

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Current Trends

- India was a global inflation outlier (in statistics - an extreme deviation from the mean) and struggled with double-digit inflation even after the 2008 financial crisis when the rest of the world was battling deflation.
- Inflation in India has now moved closer to the average of developing peers in Asia. The narrowing inflation differential is welcome.
- The trend in the three-month moving average of consumer price inflation for industrial workers shows the rise and fall in Indian inflation.

There are three possible explanations for the decline in price pressures in recent years:

- First, global oil prices have collapsed. They have remained at moderate levels despite the synchronized recovery in the global economy since early 2017. Energy analysts believe that the entry of US shale into the global energy market has effectively capped crude oil prices.
- Second, food price inflation has tumbled. Some economists argued during the episode of high inflation at the beginning of this decade, that India was facing the problem of protein inflation—as demand ran ahead of supply. There is an argument that India has now moved into an era of persistent food surpluses.
- Third, the macro policy has been tighter in recent years. The Indian central bank is now legally committed to anchoring inflation to around 4%. Inflation expectations have also drifted down. The initial record of the new inflation targeting regime (from the strategy by Monetary Policy Committee) has been a good one, though it has not yet been tested by a serious inflation shock.

Monetary Policy Committee

- The Monetary Policy Committee (MPC) is a body of the RBI, responsible for making important monetary policy decisions.
- MPC has six members. Three of the members are from the RBI while the other three members are appointed by the government.
- Members from the RBI are the Governor who is the chairman of the MPC, a Deputy Governor and one officer of the RBI. The government members are appointed by the Centre on the recommendations of a search-cum-selection committee which is to be headed by the Cabinet Secretary.
- The new balance of power in the global energy market, the shift from food scarcity to food surpluses in India and the shift to a formal inflation target will act as a check on headline inflation.

Concerns

- The most immediate one is the persistence of higher core inflation.
- The gap between headline inflation and core inflation leaves scope for two competing possibilities as far as the inevitable convergence goes. First, core inflation will fall towards headline inflation. Second, headline inflation will rise towards core inflation.
- The persistence in higher core inflation is a stumbling block in the larger narrative that India has moved into a structurally lower inflation range.
- There are two specific things here. One, the monetary policy committee has said in its February statement, that a modest output gap has opened up despite the fact that core inflation has been sticky. Two, analysts have been struggling to figure out why rural medical and education costs—a component of core inflation—have spiked in recent months.

Conclusion

- For a developing country like India, inflation plays a very important role in the growth of its economy. For example, during normal circumstances, an increase in the purchasing power (which shows that the economy is running strong i.e growing) often and also translates into inflation.
- However, the structural changes in the food market, the energy market, and the monetary policy framework offer the reason for hope. The inflation dragon may not have been killed as yet, but it seems to have been tamed.
- It is therefore risky to say that India has decisively won the battle against high inflation.

