US Inflation and Impact on India

Why in News

Over the last few days, the **retail inflation** in the US has risen to 6.2%, the highest year-on-year jump in 3 decades. These rising prices have cornered a lot of attention, both **globally and in India.**

Key Points

- **About Inflation:**
    - **Mechanism**: It is the rate at which prices increase over a given period. Typically, in India, the inflation rate is calculated on a year-on-year basis.
        - In other words, if the inflation rate for a particular month is 10%, it means that the prices in that month were 10% more than the prices in the same month a year earlier.
        - In India, inflation is primarily **measured by two main indices** — **WPI (Wholesale Price Index)** and **CPI (Consumer Price Index)** which measure wholesale and retail-level price changes, respectively.
        - India has **adopted a flexible inflation targeting** mandate of 4 (+/-2)%.
    - **Effect of Inflation on People:** A high inflation rate erodes the purchasing power of people. Since the poor have less money to withstand fast-rising prices, high inflation hurts them the hardest.
        - However, **a moderate level of inflation is required** in the economy to ensure that production is promoted.
- **Reasons for Rising Inflation in US:**
    - The Federal Reserve, the US central bank, targets an inflation rate of just 2%. Seen in that context, 6.2% inflation rate is a very sharp increase in prices.
    - Typically, inflation spikes **can be assigned to either an increase in demand or a decrease in supply.**
        - In the US, both factors are at play.
        - The **pace of economic recovery has been much faster than the supply chain recovery**, and this has worsened the mismatch between demand and supply, thus triggering a sustained price rise.
    - **Demand Side Inflation:** With the rapid rollout of the Covid-19 vaccination drive, the US economy posted a sharp recovery.
        - A part of the inflationary spike came from this unexpectedly fast recovery **in all-round demand from consumers.**
        - This recovery was **further fuelled by billions of dollars pumped by the government** to not only provide relief to consumers and those who lost their jobs, but also to stimulate demand.
    - **Supply Side Inflation**: The pandemic in 2020 **led to widespread lockdowns and disruptions not just in the US, but across the world.**

        - Companies let go of employees and sharply curtailed production.
        - In essence, the global supply chain of production hasn't resumed production on pre-pandemic levels.
    - **Inflation Globally:** While the US has seen the sharpest increase in prices, inflation has surprised policymakers across most of the major economies, be it Germany, China or Japan.
- **Inflation, Indian Perspective:**
    - **Inflation, the Pre-Pandemic Phenomena:** While most other economies were surprised by a spike in inflation in the wake of the pandemic, **India was one of those rare major economies where high inflation predates the pandemic.**
        - The pandemic did make matters worse because of supply constraints even when in India demand has not yet recovered to pre-Covid levels.
        - Due to this, despite India entering a "**technical" economic recession**, the RBI has not once lowered its **benchmark interest rates (repo rate)** since May 2020.
        - The RBI has decided **to continue with an accommodative stance** as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target going forward.
    - **Core Inflation, the Worrisome Factor**: While the overall inflation average appears quite manageable at present, it is the "core" inflation that is worrying.
        - Core inflation rate is the **rate of inflation when we ignore the prices of food and fuel.**
        - It is high, and now threatens to breach the RBI's comfort zone.
        - India's inflation may worsen in light of the global increase in prices.
- **Effect of US Inflation on India:**
    - When prices increase globally, it will **lead to higher imported inflation.** In other words, **everything that India and Indians import will become costlier.**
    - High inflation in the advanced economies, especially the US, **will likely force their central banks to abandon their loose monetary policy.**
    - A tight money policy in advanced economies **would imply higher interest rates.**
        - A tight monetary policy involves increasing interest rates to constrain borrowing and to stimulate savings.
    - That will **affect the Indian economy in two broad ways.**
        - Indian firms trying to raise money outside India will find it costlier to do so.
        - The RBI will have to align its monetary policy at home by raising interest rates domestically. That, in turn, may further raise inflation because the production costs would go up.

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