"Is Inflation Dead" - Some Comments*

Honourable Shri Jaswant Singhji, respected Dr. Sushil Wadhwani, Director General Rakesh Mohan and friends.

I am thankful to Dr. Rakesh Mohan for giving me this, opportunity. It is a matter of personal satisfaction to me to meet Dr. Wadhwani, whose lecture in London School of Economics on 'Currency Puzzles' in September won wide acclaim. Needless to say, his presentation today on 'Is Inflation dead' is bound to be another landmark speech. Its breadth and depth as also the combination of theory and practical policy are impressive. My comments would therefore be selective, basically relating to Indian situation relevant to some of the points made by him.

I will start with the conclusion where Dr. Wadhwani says: "Of course, we do not desire low inflation for its own sake, but because it might help boost growth - a recent cross-country study concluded (see Romer and Romer (1998) - "On average, the poor are much better off in countries where monetary policy has kept inflation low and aggregate demand stable."

In fact, our current approach to monetary policy reflects the same sentiment. In this context, I may quote Dr. Rangarajan that "Price stability as an objective also has social justice dimensions. In a society in which a very large segment of the population has no hedge against inflation, inflation hurts the poor the most. There can be no better anti-poverty programme than inflation control "

Another important point made in the conclusions of the paper which is of special relevance to us here and with which I readily agree, for understandable reasons is that "Inflation is, ultimately, a monetary phenomenon and keeping inflation low depends on whether there is the political will to take the sometimes difficult decisions necessary to achieve that end. Hence, designing institutions that entrench low inflation remains an important part of the policy agenda."

It is a matter of satisfaction that government has been extending necessary support to enable the Reserve Bank of India to pursue its legitimate objective of price stability of course, within some fiscal constraints. At our stage of development coordination between monetary and fiscal policies is critical, since fiscal dominance is evident although GDP is high and inflation rate is low. However, the fiscal deficit must be viewed in the context of high domestic saving and a current account deficit of less than 2 per cent of GDP. Over 90 per cent of our investments are financed through domestic saving and Government does not resort to external commercial borrowings or at floating rates. Hence, the link between fiscal deficit and external sector is not as direct and as strong as in many other countries. Similarly, with regard to the fiscal deficit of State Governments, since they are not allowed to resort to external borrowings, their domestic borrowings are approved by the Centre and Reserve Bank of India is their debt-manager and banker, the chances of their running into any unanticipated problem are relatively less. The most immediate and critical issues are, of Course, revenue deficit and financial returns on assets created out of borrowed funds.

On the specific issue of whether inflation is dead, I would readily agree with Dr. Wadhwani that one cannot be complacent about inflation and that central bankers still have a job to do. As mentioned by him, in the United Kingdom, interest rates were raised by 25 basis points on two occasions in the spirit of early, pre-emptive action; suggesting that the committee, at least, does not believe that inflation is dead. Similarly, the Federal Reserve's preemptive rate increases, three in this year, have been aimed at preventing an increase in inflation rather than reduction. In this context, it is useful to refer to a BIS Working Paper No.82 of November 1999 on 'Sacrifice ratios and the conduct of monetary policy in conditions of low inflation'. The study argues that industrial nations are sacrificing increasing amount of economic growth in their fight to lower inflation. However, it is obvious that preemptive actions such as those mentioned by Dr. Wadhwani to avoid increase in inflation are different from fight to lower inflation.

We, in India, are still in the task of ensuring price stability essentially to consolidate the gains and dampen relatively higher inflationary expectations. Incidentally, a Reuters poll of Thursday in a leading business newspaper indicates that inflation is seen as rising in most parts of Asia, except in China. Briefly stated, we in RBI cannot afford to be complacent on the inflation front.

Dr. Wadhwani has also elaborated the structural improvements in the U.K. Labour market. Our labour markets in India are admittedly very different but some studies on labour markets, and Wage inflexibilities in the context of lowered inflation should be initiated. I hope NCAER would consider them.

Of particular interest to India is the section in Dr. Wadhwani's paper on "The role of intensified product market competition". We find similar competitive pressures operating in India to subdue inflationary pressures. I had made a reference to some of these in a lecture on inflation in August 1999. Let me quote: "Increased import competition due to trade liberalisation coupled with sharp decline in world manufacturing prices could be contributing to lower manufacturing inflation through cost saving technologicial innovation and reduced mark up in domestic industries". I also said: "positive productivity shocks in the post liberalisation period due to competitive pressures might be contributing to improved price competition of industries in the domestic market."

In addition I would invite your attention to a statement by Dr. Wadhwani on role of Government action in price stability, i.e., "Privatisation and/or regulatory changes in a whole host of industries including gas, water, telecom, electricity, airports, rail, the docks and broadcasting have led to rather more competitive product market conditions." In India also, we see beginnings of similar pressure, for example, in telecommunications area.

Thanks to these developments and promise of domestic regulatory reforms, the consensus view among intellectuals on tolerable levels of inflation in India which centred round 5 to 6 per cent till two years ago, appear to be veering round now to 3 to 5 per cent, recognising the global trends towards lower inflation. The statements of monetary policy from time to time have indicated explicitly or implicitly an acceptable level or a range of inflation rate. For the current year, it was indicated in April at 5 per cent and in the October Review it was indicated that the inflation rate would be less than the last year's level, i.e., 4.8 per cent. In the last 5 years, the actual inflation rates were consistent with the ranges indicated in the policy.

In the context of monetary policy, we must recognise a recent development in regard to reserve money. With a gradual opening up of the economy and switchover to a market determined exchange rate system the net foreign exchange assets (NFA) of the Reserve Bank has emerged as the dominant source of reserve money expansion rising from about 21.4 per cent of total reserve money during 1991-94 (average of end-March figures) to 53.2 per cent at end-March 1999. While in the earlier regime, monetary policy had to address itself to the task of neutralising the inflationary impact of growing fiscal deficit, management of liquidity arising out of capital flows has also emanated as a major concern of policy.

Further, in the recent years while the stance of monetary policy has remained by and large unchanged, as indicated by Governor Dr. Jalan, the focus of monetary policy is shifting. Firstly, the shift is towards institutional changes aimed at securing greater degree of maneuverability for RBI in the management of liquidity in the economy. Secondly, the shift is also to bring about greater integration of various markets to facilitate the use of instruments of monetary control. The shift in focus is undoubtedly an outcome of the progress achieved in reforming financial sector since mid-nineties. At an analytical level, we in RBI are studying both the issues of core inflation and inflation targeting. On the specific issue of inflation targeting, which appears to be preferred, in our context, due recognition must be given to the risks and trade-off in sequencing, given the fiscal situation, interest rate inflexibilities and rigidities in the financial sector.

Central bankers all over the world are concerned with three things, money, banks and Inflation. Scope and meaning of each of these three is changing and they are in some ways becoming contextual to the country. Questions are : what is money and how is it measured, given Smart Cards. electronic and now 'e' banking. Similarly, what is a bank when banks do non-banking business and vice versa? How do we measure inflation? Do we include asset prices? All these need to be dealt with in the specific context. Of course, central bankers keep revising these definitions and the RBI is no exception. On the meaning and measurement of money, we constituted a third working group last year and we have redefined and enlarged the relevant aggregates relating to money, credit and liquidity. As regards banks, recognising the global trend, we have put out a discussion paper on universal banking last year. On inflation, we are working analytically on approaches to core inflation and inflation-targeting. We in RBI will Continue to benefit from scholarly presentations such as these.

I cannot help but place on record the fact that in recent years we have been reasonably successful on both growth and inflation fronts, it is important to mention that even during the fact of high growth during 1994-97 where the output growth exceeded 7 per cent, average inflation rate was brought down significantly from 10.9 per cent in 1994-95 to 6.4 per cent in 1996-97. During 1997-98, this rate declined further to 4.8 per cent. However, due to some supply shocks in the first half of 1998-99, the average inflation rate increased to 6.9 percent in 1998-99. This kind of durable reduction in the inflation rate is to be seen in the light of both increased competition in the economy and reform measures in the financial sector, particularly successful conduct of monetary policy.

However, the success may not be attributed only to our superior knowledge or wisdom and in this context, I cannot help agree with Dr. Wadhwani when he said in an earlier lecture "I am sure that the markets will continue to challenge us and we will need all our collective skill and perhaps an above-average dose of luck, to get our forecasts right."

Thanking you.

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* Comments on the paper "Is inflation Dead" by Dr. Sushil Wadhwani, Member, Monetary Policy Committee, Bank of England at National Council of Applied Economic Research, New Delhi on December 17, 1999