INFLATION: A Major Challenge

M. Maqbool Rather

In economics, **inflation** is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the consumer price index) over time. Inflation's effects on an economy are various and can be simultaneously positive and negative. Negative effects of inflation include an

increase in the opportunity cost of holding money, uncertainty over future inflation which may discourage investment and savings, and if inflation is rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include ensuring that central banks can adjust real interest rates (to mitigate recessions), and encouraging investment in non-monetary capital projects.

Some economists maintain that high rates of inflation and hyperinflation are caused by an excessive growth of the money supply, while others take the view that under the conditions of a liquidity trap, large injections are "pushing on a string" and cannot cause significantly higher inflation. Views on which factors determine low to moderate rates of inflation are more varied. Low or moderate inflation may be attributed to fluctuations in real demand for goods and services, or changes in available supplies such as during scarcities, as well as to changes in the velocity of money supply measures; in particular the MZM ("Money Zero Maturity") supply velocity. However, the consensus view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth. Today, most economists favor a low and steady rate of inflation. Low (as opposed to zero or negative) inflation reduces the severity of economic recessions by enabling the labor market to adjust more quickly in a downturn, and reduces the risk that a liquidity trap prevents monetary policy from stabilizing the economy. The task of keeping the rate of inflation low and stable is usually given to monetary authorities. Generally, these monetary authorities are the central banks that control monetary policy through the setting of interest rates, through open market operations, and through the setting of banking reserve requirements.

Historically, a great deal of economic literature was concerned with the question of what causes inflation and what effect it has. There were different schools of thought as to the causes of inflation. Most can be divided into two broad areas: quality theories of inflation and quantity theories of inflation. The quality theory of inflation rests on the expectation of a seller accepting currency to be able to exchange that currency at a later time for goods that are desirable as a buyer. The quantity theory of inflation rests on the quantity equation of money that relates the money supply, its velocity, and the nominal value of exchanges. Adam Smith and David Hume proposed a quantity theory of inflation for money, and a quality theory of inflation for production.

Currently, the quantity theory of money is widely accepted as an accurate model of inflation in the long run. Consequently, there is now broad agreement among economists that in the long run, the inflation rate is essentially dependent on the growth rate of money supply relative to the growth of the economy. However, in the short and medium term inflation may be affected by supply and demand pressures in the economy, and influenced by the relative elasticity of wages, prices and interest rates The question of whether the short-term effects last long enough to be important is the central topic of debate between monetarist and Keynesian economists. In monetarism prices and wages adjust

quickly enough to make other factors merely marginal behavior on a general trend-line. In the Keynesian view, prices and wages adjust at different rates, and these differences have enough effects on real output to be "long term" in the view of people in an economy

In the past, many distinguished economists have argued that for the sake of growth and long-run stability, as well as for reasons of social justice, it is preferable that prices should be allowed to fall when technological improvements lead to a decline in the average cost of production (rise in output per head). This is equivalent to saying that inflation in the sense of a rise in money income (or expenditure) per head should be avoided. Much is to be said for this view on grounds of social justice. For instance, when prices decline receivers of fixed money incomes, such as pensioners, beneficiaries of life insurance, and holders of bonds and savings deposits share in the fruits of economic progress which some of them through their frugality have helped to bring about.

Many different factors and policies have been held responsible for inflation. Some say aggregate demand rising faster than aggregate supply "pulls up" prices and wages ("demand-pull inflation"). The rise in demand in turn may be due to a government deficit ("government inflation") or to an expansion of bank credit for private investment ("credit expansion") or rising demand from abroad ("imported inflation") or an increase in gold production ("gold' inflation"). Others say prices are being "pushed up" by wage increases forced upon the economy by labor unions under threat of strike ("wage-push inflation"), or costs may be raised by business monopolies ("administered price inflation"). To these positive factors can be added negative ones-for example, the failure of overall output to grow or of savings to stay on their "normal" level-factors for which, in turn, different causes may be found. It is not difficult to think of conditions under which one or the other of these hypotheses would be valid and for several of these possibilities actual examples can be found in recent economic history.

A connection between inflation and unemployment has been drawn since the emergence of large scale unemployment in the 19th century, and connections continue to be drawn today. However, the unemployment rate generally only affects inflation in the short-term but not the long-term. In the long term, the velocity of money supply measures such as the MZM ("Money Zero Maturity," representing cash and equivalent demand deposits) velocity is far more predictive of inflation than low unemployment.

Food inflation in India has been a major challenge to policy makers, more so during recent years when it has averaged 10 percent during 2008-09 to December 2012. Given that an average household in India still spends almost half of its expenditure on food and poor around 60 percent (NSSO, 2011), and that poor cannot easily hedge against inflation, high food inflation inflicts a strong 'hidden tax' on the poor. Correct diagnosis about the nature, structure, and factors influencing food inflation, therefore, is critical for any rational policy decision to contain it

within comfortable limits. Accordingly, this study finds that the pressure on prices is more on protein foods (pulses, milk and milk products, eggs, fish and meat) as well as fruits and vegetables, than on cereals and edible oils, especially during 2004-05 to December 2012. This normally happens with rising incomes, when people switch from cereal based diets to more protein based diets. Economic literature on factors that could plausibly explain food inflation in India, coupled with econometric analysis, reveals that three factors stand out in this regard: ballooning/monetized Fiscal Deficit, rising farm wages, and transmission of the global food inflation; together they explain 98 percent of the variations in Indian food inflation over the period 1995-96 to December, 2012. The study takes 1995-96 as the starting point as major changes in agri-trade policies were ushered in at that time, which paved the way for gradual integration of Indian agriculture with global markets. Based on the empirical results of the econometric analysis, it is suggested that the policies to rein-in food inflation will foremost require winding-down fiscal deficit, which has gone (above 8% of GDP for Centre and States combined) way beyond the guidelines laid out in FRBM Act, 2003. In this context, rationalizing and pruning fuel, food, and fertilizer subsidies would be important, at least at the Central level. CACP's calculations show that direct transfer of food and fertilizer subsidies in cash to targeted beneficiaries has the potential to save almost Rs 60,000 crores, without any major adverse impact on the beneficiaries. This would require political courage as well as innovative ways to implement direct cash transfers to targeted beneficiaries through Aadhaar.