Dealing with inflation

What is the issue?

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- There has been demand to lower the interest rates since the inflation slipped to 1.54%.
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- Economists, however, suggest that the monetary policy should not formulated based upon inflation.
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How is inflation understood in India?

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- India opted for the Monetary Policy Committee to deal with **inflation targeting**.
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- This has led to an idea that the central bank will now be judged entirely in terms of its record on inflation.
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- The model underlying inflation targeting is that inflation reflects output being greater than the economy's 'potential'. This is called the **output gap model.**
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- The proposed demand now is to bring output back to its potential level via an interest rate hike.
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How is it a flawed model?

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- The problem with this model is that the potential level of output is unobservable, uncertain and is highly variable.
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- This flaw is evident given the **agriculture sector** of India, where production fluctuates to a large extent with subsequent fluctuation in prices.
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- Now, when the relative price of agricultural goods rises due to slower growth of agriculture, the inflation rate rises.
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- Such an inflation has nothing to with an economy-wide imbalance gap as visualised in the 'output gap model' underlying inflation targeting.
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- With this perception, the slow growth in other sector of economy, manufacturing, is going unnoticed.
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- Rising interest rate as a response to rising agricultural prices would only be at the cost of output loss in the non-agricultural sector.
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- The drawback with new arrangement is that **RBI cannot be held responsible for what happens to growth as it is to be judged entirely by what happens to inflation.**
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What is the way out?

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- Developing countries such as India have an economic structure different from the developed ones of the West for which inflation targeting was first devised.
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- Inflation targeting should be based on a proper understanding of inflation in the Indian context.
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- It is to be recognised that even though the RBI cannot directly move agricultural prices, its response to their movement matters.
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- RBI and the MPC have to acknowledge that they have erred in taking real rates in India to the highest level in 16 years.
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- As agricultural price inflation continues to fall, driving down the overall inflation rate, the real rate of interest rises.

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- If the central bank does not respond by lowering the policy rate, the real rate of interest will continue to rise, with negative consequences for non-agricultural output.
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- Inflation control now requires supply management.
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Source: The Hindu

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