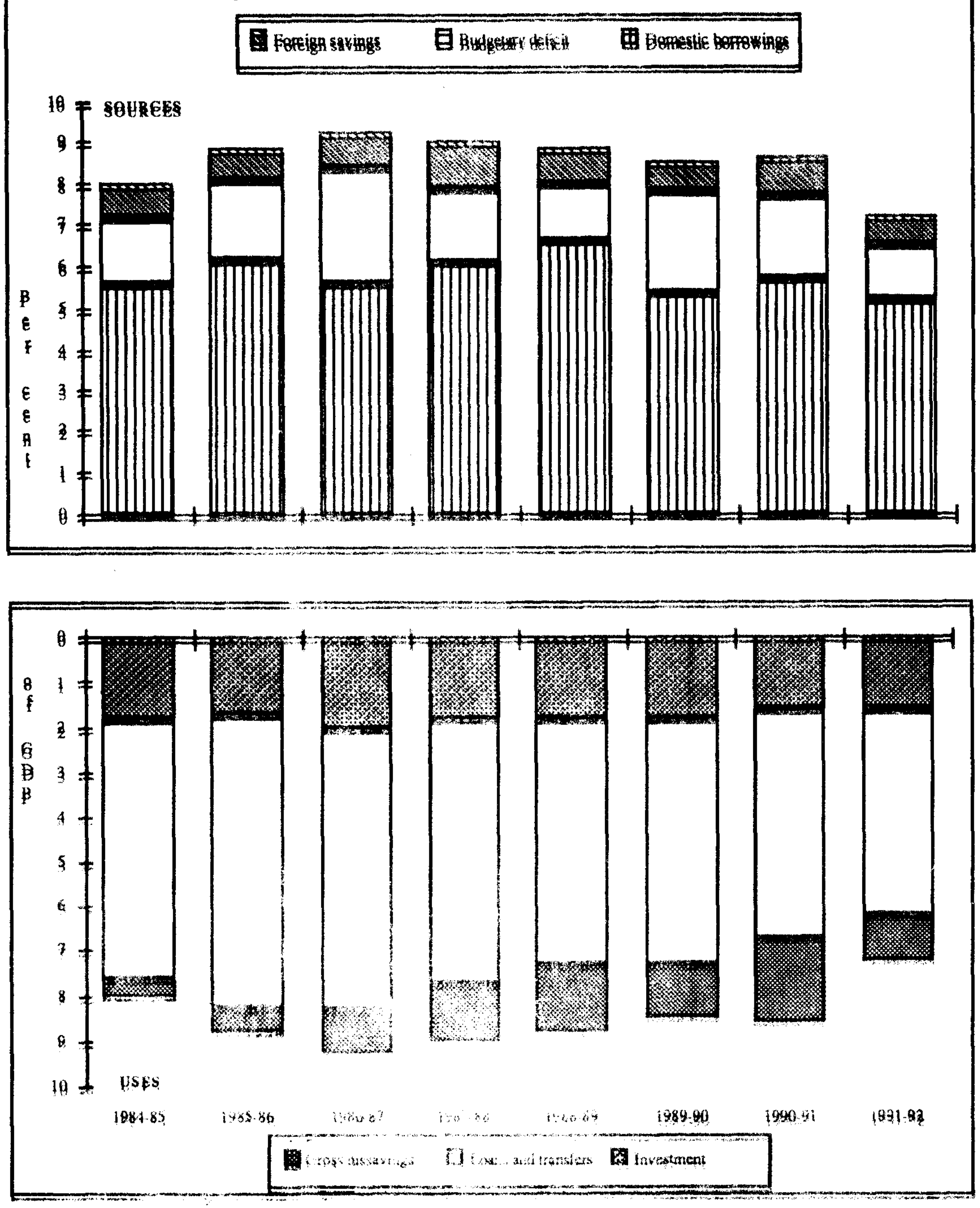
III INFLATION

The current inflationary spiral began in October 1990. In August and September 1990, the annual rate of inflation, as measured by the wholesale price index on a point-to-point basis, was only about 7 per cent. From October onwards it rose rapidly to reach 13.7 per cent in February 1991. After a brief slowing down in April and May, this process of accelerating inflation continued until August 1991, peaking in the fourth week of that month at 16.7 per cent. Since then the rate of inflation has declined; by the end of January it had gone down to 11.8 per cent (Figure 6).

The causes of the current round of inflation need to be understood clearly if we are to control it effectively. A number of demand-pull and cost-push factors have been mentioned as potential causes. On examination, excess demand is found to be the more important cause. This is indicated by the pattern of price changes, with primary commodities, particularly agricultural goods, leading the inflationary surge. Manufactured goods prices have not even kept pace with average inflation, and have lagged well behind the rise in agricultural prices. The inter-sectoral terms of trade for agriculture improved by 15 per cent vis-a-vis industry between April 1991 and January 1992.

Along with demand-pull factors which are more important, supply factors have also played their role in the current inflationary process. Supply factors determine the pattern of relative price changes, as overall excess demand puts greatest pressure on prices in sectors which have low elasticity of supply or which face supply constraints. At the start of the current inflationary phase, the prices of fuels and lubricants as well of primary goods jumped sharply. The rise in the former was triggered by the supply disruption and the increase in oil prices resulting from the Gulf War. The rise in

Fig. 7 SOURCES AND USES OF CENTRAL GOVERNMENT FUNDS (1984-92)



agricultural prices, on the other hand, was fuelled by a rather poor kharif crop of 1990 which followed on the heels of a poor rabi crop earlier in the same year. As a consequence, relative prices of both primary commodities and fuel and lubricants rose.

Imports could not be used to increase supplies and dampen prices because of the severe balance of payments problems being faced during this year. The resulting relative scarcity of primary goods also generated inflationary expectations which spread to all sectors of the economy and encouraged inventory accumulation. The sharp increase in procurement prices for foodgrains over the last two years and some cash crops has also contributed to inflationary pressures.

The excess demand pressures in the economy were primarily generated by expansionary fiscal policies of Central and State Governments in previous years. The investment expenditure of Central and State Government combined has considerably exceeded their savings. Although Government investment as percentage of GDP declined, the decline in Government savings was even faster. Not only has the Government sector borrowed from domestic savings pool to finance investment in recent years, Government consumption expenditure has also come to be financed out of borrowings. Gross savings of the Central Government have been persistently negative; in 1990-91 these amounted to 1.9 per cent of GDP (Figure 6). The excess demand of the Government, represented by its excess of investment over saving, has been met from three sources : domestic borrowing, foreign borrowing and borrowing from Reserve Bank of India. As Figure 7 shows, Government borrowings in the domestic capital markets have financed only about 70 per cent of Government-financed capital formation and excess consumption in recent years. The rest came from borrowings from Reserve Bank of India and borrowings abroad. A large part of Government commercial borrowings in the domestic market are from the banking system, which lends to the Government through the operation of the the Statutory Liquidity Ratio (SLR). Over the years, the statutory liquidity ratio has risen to 38.5 per cent. The return on Government securities issued to meet the SLR requirements is low. Further increase in the SLR is not possible because it erodes the banks' ability to finance productive investment in the economy. There is a strong case for lowering it. If it is brought down, however, the access of the Government to private savings through the banking system will decline.

In an open economy, the excess of expenditure over domestic borrowing would spill over into a balance of payments deficit. India's balance of payments position is so constrained that such a relief is not always available. Foreign borrowings are no longer freely available to finance such expenditures or to moderate price increases through imports.

Figure 6 also brings out the connection between domestic and foreign savings which are alternative sources for financing domestic investment. If the recourse to foreign borrowings is to be reduced, either domestic investment must be reduced with undesirable consequences, or domestic savings must be raised. There is thus an unavoidable connection between improving the balance of payments and improving the domestic savings-investment balance. As the leading excess investor and consumer as well as borrower from abroad, the Government bears the prime responsibility in both respects: it needs to bring down its dissavings.

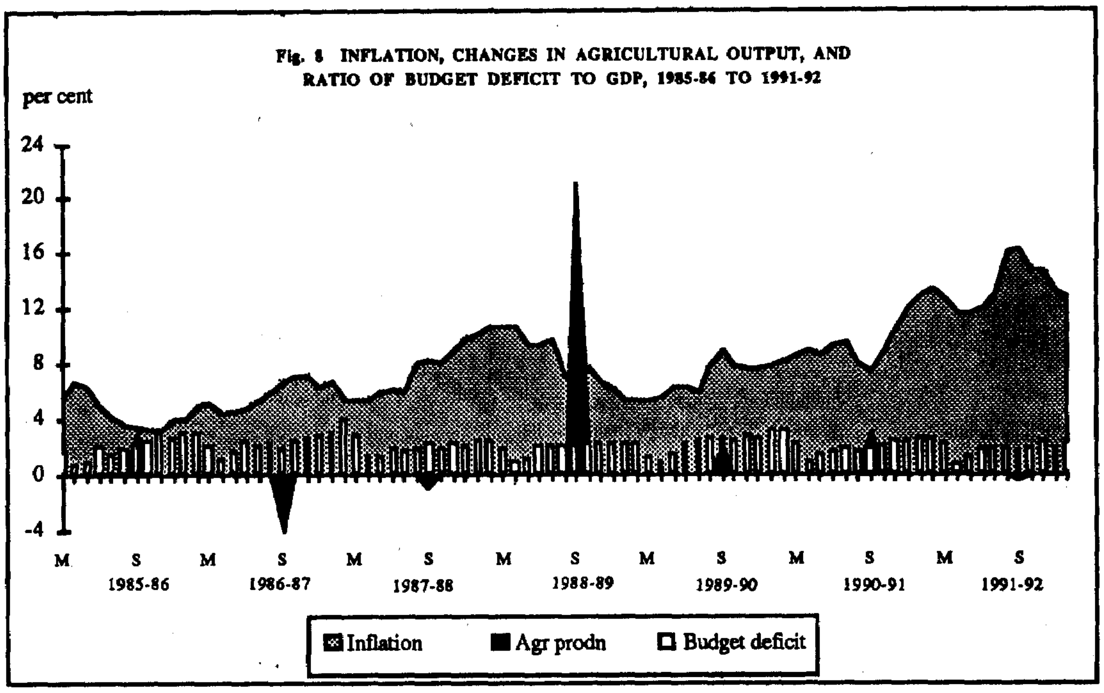


Fig. 8 INFLATION, CHANGES IN AGRICULTURAL OUTPUT, AND RATIO OF BUDGET DEFICIT TO GDP, 1985-86 TO 1991-92

Apart from commercial borrowings and external borrowings, the third source of financing for the Government is borrowings from Reserve Bank of India. This is directly connected to the expansion of money supply and consequently to inflation. The monetized deficit (that is, the part of the fiscal deficit that leads to an increase in money supply) rose from 1.6 per cent of GDP in 1988-89 to 3.1 per cent in 1989-90 and 2.8 per cent in 1990-91. Even within the year, the monetized deficit of the Central Government shows a fair degree of correspondence with the rate of inflation (Figure 8). Apart from the immediate net increase in expenditure, monetization of the deficit builds up a liquidity overhang which fuels a general increase in demand in succeeding years. The Budget for 1991-92 was designed to bring down the monetized deficit to 1.3 per cent of GDP from 2.8 per cent in 1990-91. The effect of fiscal correction is likely to be felt only by the last quarter. Its impact has, however, been offset to some extent by the buildup of foreign exchange reserves after July 1991, which have replenished money supply (M3).

Thus the Government needs to reduce its reliance on all the three present sources of funds: compulsory borrowings through the banking system, the monetized deficit, and foreign savings.

In order to reduce the fiscal deficit, the Government has had to permit an increase in some administered prices of basic goods and services. These price rises have been due for some time. They could not be avoided any longer if fiscal deficits had to be reduced. Losses of public sector enterprises which result from not permitting an increase in administered prices are financed from the general Budget. They lead to budgetary deficits and to an increase in borrowings from Reserve Bank of India. Admittedly, a rise in administered prices does raise costs in the user sectors. However, if fiscal and monetary policies effectively control aggregate demand, the increased costs cannot generate an inflationary spiral. By contrast, an increase in the budget deficit would intensity generalized inflationary pressures in the economy.

Inflation has an adverse effect on the standards of living of the poorer sections, especially those whose incomes are not indexed to price increases. The Government is conscious of the need to mitigate these adverse effects as far as possible. Thus, the public distribution system has been further expanded to cover 1700 far-flung and disadvantaged blocks. In addition to regular PDS supplies, 1.5 million tonnes of foodgrains have been off-loaded in open market sales between November 1991 and January 1992 through the Food Corporation of India (FCI). Imports of edible oils have been stepped up in recent months. The Government will do all at its command to break the inflationary expectations and prevent speculators and hoarders from making unjustified profits.

Other measures which have to be taken for lowering the rate of inflation in the economy are :

(i) Reducing subsidies and external support to production enterprises so as to make them more responsive to price and demand changes. In some cases today the enterprises are more concerned about the fiscal concessions and subsidies which they are receiving than with earning profits from sales. This should change.

(ii) Ensuring that buffer stock operations for foodgrains and intervention in agricultural markets are counter-cyclical. Thus in years of relatively poor harvest, the FCI should procure a lower percentage of market arrivals and off load larger stocks in the market. In good years the procurement can be higher and be used to build up stocks.

(iii) Encouraging savings to remain high not only as a proportion of GDP but in relation to demand for investment funds in the economy.

(iv) Keeping entry barriers low in the industrial sector and improving industry's access to imported inputs at low tariffs.

(v) Improving technological and managerial capabilities with a view to shortening the response time of enterprises to price and demand changes, both in the domestic and international markets.

(vi) Improving operational efficiency and expanding capacity in infrastructural industries. This would require an overhaul of the inherited organizational structures in these sectors and greater use of markets in determining their operations.

With the above measures, it will be possible to make the economy more inflation-proof and more dynamic.