Subir Gokarn: Managing the growth-inflation balance in India – current considerations and long-term perspectives

Keynote address by Dr Subir Gokarn, Deputy Governor of the Reserve Bank of India, at the Private Equity International India Forum, Mumbai, 5 October 2010.

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Introduction

I would like to thank the Private Equity International India Forum for inviting me to deliver this Keynote Address. I believe that channels of finance like venture capital will play an increasingly significant role in India. Sustaining the current growth momentum over a long period of time will clearly depend heavily on the ability of new business ideas to first, find start-up funding and then, grow to scales at which traditional funding sources can be accessed. Historically, this role was played in the Indian economy by the Development Finance Institutions. In the current and future scenario, the function has shifted to companies like the ones represented at this forum, whose business model depends on successful navigation of the start-up to listing phase of the businesses that they finance. In turn, the likelihood of success depends on a stable and predictable macroeconomic environment.

The long-term growth prospects of the Indian economy provide an enormously attractive investment environment for a range of businesses and, consequently, for the people who would finance them. However, as attractive as the opportunity may seem, the assessment would not be complete without a full understanding of the risks. In my address this morning, I will focus on the risk of macroeconomic instability, with particular emphasis on the issue of inflation: what drives it and whether it threatens to get out of control. An unavoidable consequence of runaway inflation, however we define it, is that drastic action by the central bank and also by the government is needed to rein it in, which is bound to disrupt the growth process. The challenge, therefore, is to keep inflation in check over long periods of time, allowing the economy to grow at its potential rate with minimal disruptions and deviations. This is the best way in which the macroeconomic environment can contribute to a positive business climate.

I will begin by discussing the current inflationary scenario in India, which, as we have been saying in our recent assessments, is not very reassuring. I will then place this scenario in a broad historical context, with the intention of demonstrating that India has a good record of reining inflation in, regardless of what has driven it. The structure of the domestic economy and the financial system may have changed and the global context may be different, but the effectiveness of inflation control over the decades has not diminished.

The current scenario

As you well know, the predominant policy concern in the Indian economy as recently as one year ago was the significant slowdown in growth in the wake of the financial crisis in the advanced economies. As Slide 1 shows, the inflation rate, which was briefly negative in the middle of 2009, began to accelerate rapidly later in the year. This upward momentum continued into the first half of 2010, with double-digit inflation persisting for a few months. The rapidity of the transition was surprising, given the fact that the recovery in growth was just getting under way and, importantly, the global situation was still very uncertain. However, as Slides 2 and 3 indicate, the reason for the sharp increase was that all the possible drivers of inflation were simultaneously contributing. Each one by itself may not have resulted in the outcome that we saw, but all three working together resulted in a rather sharp acceleration. Slide 2 displays the pattern of supply-side pressures, as manifested in the food and fuel components of the Wholesale Price Index. Food prices rose sharply because the monsoon of 2009 was deficient in most parts of the country, impacting agricultural production. However, there are, I believe, longer term forces at work on food prices, which are a matter of concern. I shall address these later on in the speech. Fuel prices also rose as the prospects of a global recovery improved and, particularly, the Emerging Market Economies actually saw a sharp acceleration in growth.

However, what was most significant from the monetary policy perspective was the growing visibility of demand-side pressures. Slide 3 tracks the price dynamics of the manufacturing sector – overall and without the food processing component. The latter has been used by many analysts as a reasonable proxy of demand-side inflation, which is the phenomenon that monetary policy can and should influence. Both graphs in the slide and, particularly the one displaying non-food manufacturing inflation, show a tremendous acceleration from a significantly negative rate of inflation during 2009 to reach rather worrisome levels by the middle of 2010.

Slide 4 compares the relative contributions of the supply and demand drivers. The graph shows quite clearly that food and fuel prices, reflecting supply-side forces and the prices of manufactured goods, reflecting demand-side ones, all contributed significantly to the recent rise in inflation. If we look back a little at the inflationary surge immediately preceding the crisis, we can see that the pattern is quite similar. This leads me to a broader point about the drivers of inflation in India. Whenever we see worryingly high levels of inflation, both supply and demand pressures seem to be at work.

The final point in the discussion on the current scenario is with reference to monetary policy responses. Slide 5 shows displays the movement of the overnight call money rate, which reflects the combined actions taken by the Reserve Bank on policy rates and liquidity. To place the recent policy actions in perspective, we must remember that the response to the crisis involved an enormous reduction in both policy rates and the cash reserve ratio in late 2008 and early 2009. Along with this, a number of ad hoc measures were also taken. As the crisis abated, even if inflationary pressures had not manifested as they did, the need to exit from the crisis management stance would have motivated some actions on rates and liquidity – of course, at a pace that would not derail the still incipient recovery.

This process began in October 2009, with the withdrawal of most of the ad hoc measures, but gained momentum in January 2010, with an increase in the cash reserve ratio and, further, in March 2010 with the first of a series of rate hikes. The pace and sequencing of actions was, as we articulated in our various assessments, determined by the need to balance a number of potentially conflicting factors. First, we needed to address the rapidly mounting demand-side inflationary pressures while ensuring that the recovery was not cut short by a surge in interest rates. Second, while the domestic economy was doing well, the global environment remained uncertain, with a number of new stress points emerging periodically.

Third, apart from everything else, it was imperative that we normalize the monetary policy stance from where it had moved during the crisis management phase. Not doing so would have put us in the situation of being unable to respond to another negative shock, were it to materialize. In sum, our policy actions over the past several months were motivated by the twin objectives of sustaining the recovery while reining in inflation and normalizing the policy stance as quickly as possible. In our mid-quarter assessment last month, we indicated that the normalization process is now close to being complete and that further actions on rates and liquidity will be driven more significantly by what the growth and inflation numbers tell us, both domestically and globally.

Of course, the proof of the pudding is in the eating. Do we believe that our actions are having the desired effect? On the growth front, while there is a certain amount of volatility visible in industrial production, by and large, there is no significant indication of the recovery stalling. On the inflation front, as was visible in the slides that I showed earlier, there are distinct signs of a deceleration of inflation over the past couple of months. The turnaround coincides with our expectation that inflation begins to respond to monetary actions after a six month lag. To examine this more closely, we look at the Seasonally Adjusted Month-on-Month rates of inflation, which give a sense of the momentum of inflation. Slide 6 displays the pattern of this indicator. It clearly suggests that the momentum is currently negative. While the turning point on the overall index is early in 2010, the sharp deceleration in recent months may reflect the impact of monetary actions and gives us confidence that the inflation rate will moderate significantly by the end of the fiscal year 2010–11.

I would like to conclude this discussion by emphasizing the point that the current episode of inflation posed a significant challenge to policymakers by virtue of its timing. Monetary policy responses had to be calibrated to the needs of dealing with inflation while sustaining a growth recovery in a still uncertain global environment. The choices on the magnitude, sequencing and timing of actions were driven by the need to find a balance between these factors.

Long-term perspectives

Let me now take a longer term view of the growth-inflation balance in the Indian economy. To begin with, we do have a fairly explicit statement of what we see as a desirable rate of inflation, consistent with the economy growing at its potential rate on a sustained basis. Our policy reviews say that we would like inflation to be in the 4–4.5 per cent range in the medium-term, while aspiring for a 3 per cent rate in the long term. This might sound a little unrealistic in the current scenario, but in order to both justify the aspiration itself as well as assess its realism we need to look at the historical record of inflation management in the Indian economy.

Slide 7 provides a very revealing picture of how the growth-inflation balance has shifted in the Indian economy. The first graph, relating decadal averages of growth and inflation over the past several decades clearly indicates that a steady upward movement in the growth rate has been accompanied by a steady downward movement in the inflation rate. The contrast is even more striking when we remove the agricultural sector, which is the slowest growing among the three – Agriculture, Industry and Services – over long periods of time, from the growth calculations. These patterns clearly suggest that there is no long-term trade-off between growth and inflation; if anything, accelerating growth is accompanied by decelerating inflation.

This may appear to be an obvious conclusion. The textbook treatment of the growth-inflation trade-off sees it as an essentially short-run phenomenon, with the quantum of resources and capacity in the economy being fixed. However, the reason I specifically mention this point is that in the wake of recent assessments that the Indian economy is poised to significantly increase its growth rate many people have asked me whether this will be accompanied by an inflationary surge. My answer to this is precisely with reference to the distinction between the short-run and the long-run relationship between growth and inflation. In the short-run, with capacities fixed, a surge in growth can cause the economy to overheat, thus stoking inflationary pressures. This is the bread-and-butter issue of monetary policy, the effectiveness of which must be judged by its ability to keep the economy growing at a rate just short of overheating, thereby keeping inflation in check.

In the long run, capacities are not fixed. Acceleration in growth over long periods of time occurs in part because investment activity, which itself contributes to growth, leads to an increase in capacity. This pushes up the potential growth rate of the economy, i.e., the rate at which it can grow without causing overheating. Looking back over the growth performance of the Indian economy, it is quite evident that the acceleration of growth from the 5–6 per cent range to the 8–9 per cent range was accomplished by a massive increase in investment. As

Slide 8 indicates, the Investment-GDP ratio rose quite sharply over the decades. Even the relatively high number of 30.5 per cent during the last decade masks the sharp surge in this ratio towards the middle of the decade, which saw it rise above 35 per cent. At that rate of investment, the capacity of the economy to increase output is growing quite rapidly and its ability to meet the requirements of a growing and increasingly affluent population is clearly expanding.

In short, the secret to accelerating growth while still being able to keep inflation in check over long periods of time is in the speed and efficiency of the supply response. As long as the growth in supply keeps pace or even exceeds the growth in demand, inflationary pressures do not sustain. Supply can be expanded by enhancing domestic capacity, which the Indian economy has clearly done, or by tapping into global sources, which the significant liberalization in trade policy, particularly since the early 1990s, also enabled.

However, while this combination of domestic and global supply responses has helped to steadily bring the inflation rate down, the Indian economy has always been vulnerable to inflation shocks, which have caused uncomfortable spurts in prices across the board. Slide 9 identifies some major shocks to the system, all of which required strong policy responses. As is evident from the graph, the vulnerability of the Indian economy to supply shocks on the food and energy fronts is persistent. There have also been periods in which a significant fiscal expansion accompanied by an accommodating monetary stance – i.e., demand-side pressures – raised the inflation rate significantly. Sharp depreciation of the rupee in the midst of an oil shock has also played a role on one occasion. While the demand driven inflation shocks can be avoided by prudent monetary and fiscal policies, the vulnerability to supply shocks in the form of a failed monsoon or a surge in oil prices will obviously remain.

Slides 10–12 display some of the characteristics of the transformation of the inflation scenario in India. On Slide 10, we see how the relative contributions to inflation have changed over the decades. Food has been a steady source of inflation over the entire period. Energy became a significant factor during the 1970s, following the first oil shock of 1973. It has persisted in its contribution since then. Adding up the two provides the overall contribution of supply-side factors, which, as the graph suggests, have persisted in one form or another through the entire period. Looking ahead, it would be reasonable to argue that these pressures are likely to persist, as a result of both global and domestic imbalances between demand and supply.

On the energy front, one of the fundamental drivers of high oil prices is increasing demand in Emerging Market Economies, whose rising affluence is resulting in very rapid growth of energy-intensive activities. As relatively low-cost reserves of fossil fuels are exhausted, rising global demand is being met by exploiting higher cost sources. The cost differential between petroleum and alternative sources makes such sources viable even at their relatively high costs. Steadily rising costs of production, in turn, exert inflationary pressures on the global economy, which hits those economies hardest whose energy intensity is increasing most rapidly. In recent years, the prices of petroleum, as well as other commodities, are perceived to have been further impacted by their emergence as an attractive asset class. However, as significant as the contribution of this factor may have been to price increases, the underlying fundamentals are what will continue to drive prices in the coming years.

As regards food, the pressures in the Indian economy are predominantly domestic. Our Green Revolution in the 1960s raised the production of cereals dramatically, which increased availability and stabilized prices. However, what we are seeing today is the impact of increasing affluence on the demand for a variety of food items that go far beyond cereals. As people become more affluent, their diets diversify. Just as the growing Indian consuming class has stimulated a boom in the demand for consumer durables, vehicles and mobile phones, to give but a few examples, it has also manifested an enormous increase in the demand for various food items beyond cereals. Demand for protein sources – pulses, milk, meat, fish and eggs – has surged as has the appetite for sugar, fruits and vegetables.

In the case of consumer durables, vehicles and mobile phones, the expansion in capacity was enormous and rapid, resulting in the demand being met without prices increasing. In fact, economies of scale and technological advancements actually helped to bring down the prices of many products even as volumes were increasing. The globalization of the supply chain also contributed significantly, as global capacities were brought into play to meet the rising demand. This combination of forces has certainly not been in play in meeting the rising domestic demand for the food items mentioned above. Supply is predominantly domestic and, for the most part, is unable to respond effectively to the expansion in demand. The inevitable consequence of this is an increase in prices. This is a significant structural driver of inflation in the Indian economy. A good monsoon may provide some relief, while a bad one will aggravate the pressures, but the enduring solution to this problem lies in a rapid and sustained increase in the supply of these items.

Slide 10 also displays the positive impacts of effective supply response. The contribution of manufactured goods to inflationary pressures has declined significantly over the decades. This decline can be attributed to increasing effectiveness of policy reforms in increasing domestic capacities and competition and integrating domestic markets with the global supply chain.

In Slide 11, we look at inflation dynamics from the macroeconomic policy perspective, i.e., monetary and fiscal actions that may have contributed to the rise and fall of the inflation rate. During the 1970s and 1980s, the monetization of the fiscal deficit, as reflected in the height of the bar showing the growth in net RBI Credit to Government, was clearly a contributor to inflationary pressures in the economy. Government spending boosts demand and if the government faces no effective financial constraints, it can increase spending without limit and, certainly beyond the capacity of a relatively closed economy to meet the demand.

The emergence of an effective constraint on monetization of the fiscal deficit during the 1990s helped to rein this source of inflationary pressure in. Now, if the Government wants to increase its spending, it has to raise resources from the market, bringing in some realistic cost-benefit calculations, including the fact that the cost of funds for the private sector will also increase. Against this backdrop, the Government’s commitment to fiscal prudence in the form of fiscal responsibility legislation is an important contribution to maintain the growth-inflation balance.

It is also striking in Slide 11 that, contrary to popular notions about the link between the growth in money and the inflation rate, the rate of growth of money remained constant even as inflation declined. The reason for this was that the expansion in money was absorbed by the growing volume of transactions that involved money exchange. This absorption mitigated the potentially inflationary impact of money growth.

One important consideration in inflation management is the stability of the inflation rate. Forward-looking transactions build in some expectations about inflation rates over the tenure of the contract. Significant deviations of actual outcomes from expected ones can cause huge losses to one of the transacting parties, thereby acting as a deterrent to what may be growth-enhancing transactions. The more stable the inflation rate, the less these deviations will be. There appears to be an almost universal correlation between the level of the inflation rate and its stability. As Slide 12 shows, this relationship is quite evident in the Indian context. The reduction in the average inflation rate over the years has been accompanied by a sharp reduction in the volatility of that rate. The aspiration of a “low and stable” inflation rate is a realistic one.

Finally, let me make a few comments on the role of monetary policy in this transition from a relatively high-inflation economy to a relatively low-inflation one. Conventional monetary policy began to apply only during the 1990s, with the freeing up of restrictions and mandatory allocations of credit to various sectors. Genuine markets for both products and credit emerged after the reforms of the early 1990s. As Slide 13 shows, the persistent inflationary conditions during the 1990s were responded to by significant monetary actions in terms of both rates and liquidity management. As the inflation rate trended lower, a process to which the monetary policy actions of the period contributed, the policy stance in turn changed to accommodate the new circumstances. In other words, monetary policy has been aimed at keeping inflation under control, which involves tightening when inflation exceeds the comfort level and loosening when it falls below.

Concluding remarks

The current inflation scenario is a cause of concern, as the inflation rate persists well above the upper bound of the comfort zone. The fact that these inflationary pressures emerged rather quickly in a situation in which the economy was just beginning to recover from the significant slowdown of 2008–09 made the policy challenge more complicated. The monetary policy response to these pressures has been a calibrated one, seeking a balance between sustaining the recovery and reining in inflation, while being mindful of the risks that still remain in the global environment. Recent data suggest that the approach is working, with the economy set to grow at a reasonably healthy rate during the current year and the inflation rate beginning to decline, including, significantly, in the manufacturing sector, where inflation is seen as being most responsive to monetary actions.

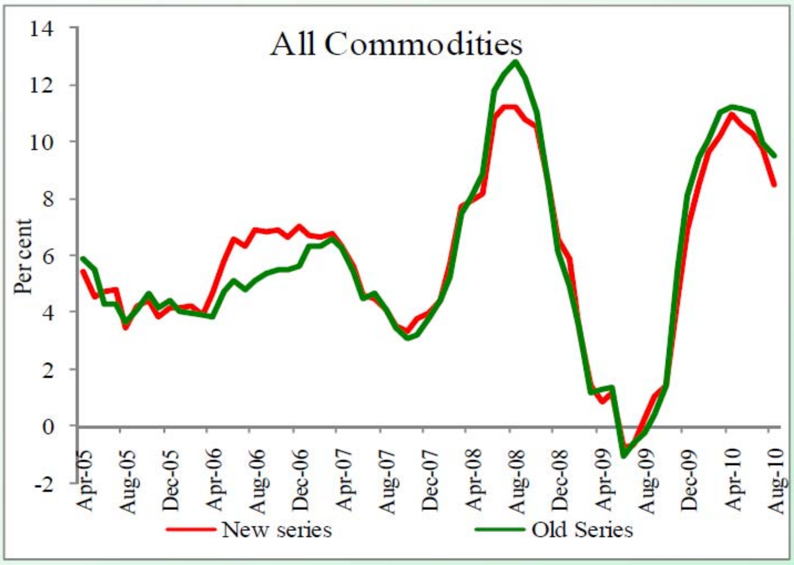
This approach must be viewed in the context of a long-standing policy commitment to maintain a balance between growth and inflation in the short run, while fostering faster growth with lower inflation over long periods of time. The growth pattern of the Indian economy over the past six decades clearly shows that accelerating growth has been accompanied by declining inflation. This is primarily because growth has been driven by expanding capacities across the board as well as, in recent years, by increasing global linkages. Both these factors have helped to achieve a strong supply response to growing demand, thus keeping inflation in check.

This is not to say that the Indian economy is now invulnerable to inflation shocks. Food and energy price shocks have been a regular part of the economic landscape and may continue to be so in the future. Food prices, in particular, are now being driven by some structural imbalances between demand and supply, as increasingly affluent consumers diversify their dietary patterns away from cereals and towards protein sources. This calls for an effort to quickly increase the availability of these items, on which is contingent the longer term outlook for food price inflation.

However, over the years, both fiscal and monetary policy approaches have clearly assimilated the lessons of the past and have moved in a direction which helps contain inflationary pressures even as growth remains robust. Making inflation low and stable was the outcome of a combination of long-term and short-term policies over the past decades. Keeping it there remains the objective, while an appropriate combination of long-term and short-term policies will provide the instrument to achieve it.

I thank the organizers of this event once again for giving me this opportunity and thank you for listening.

Slide 1: Recent Inflation Dynamics



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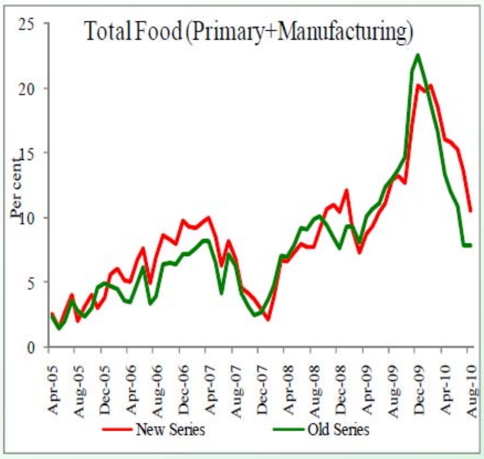
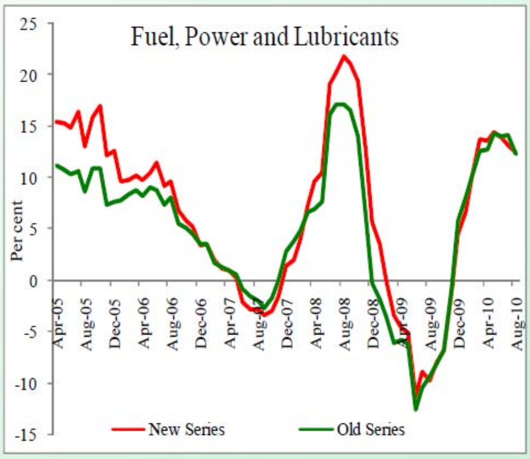
Slide 2: Supply-side Pressures





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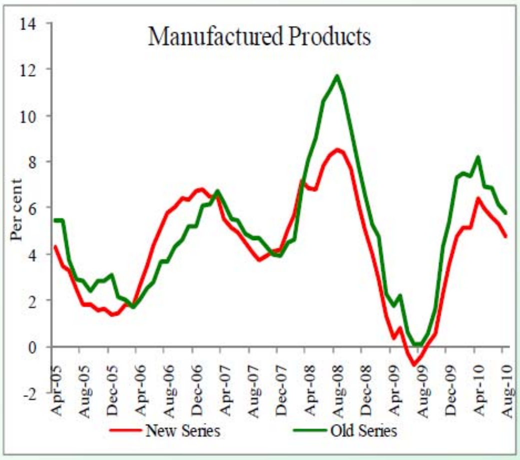
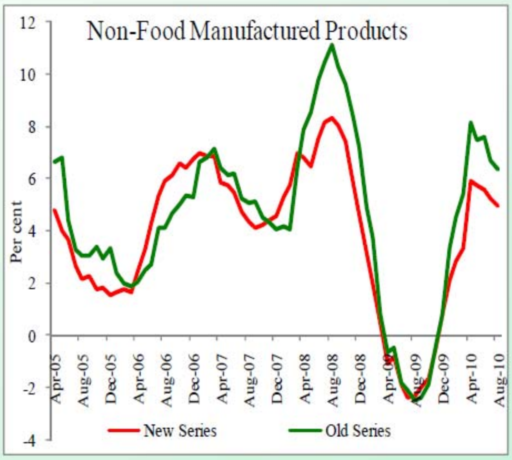
Slide 3: Demand-side Pressures





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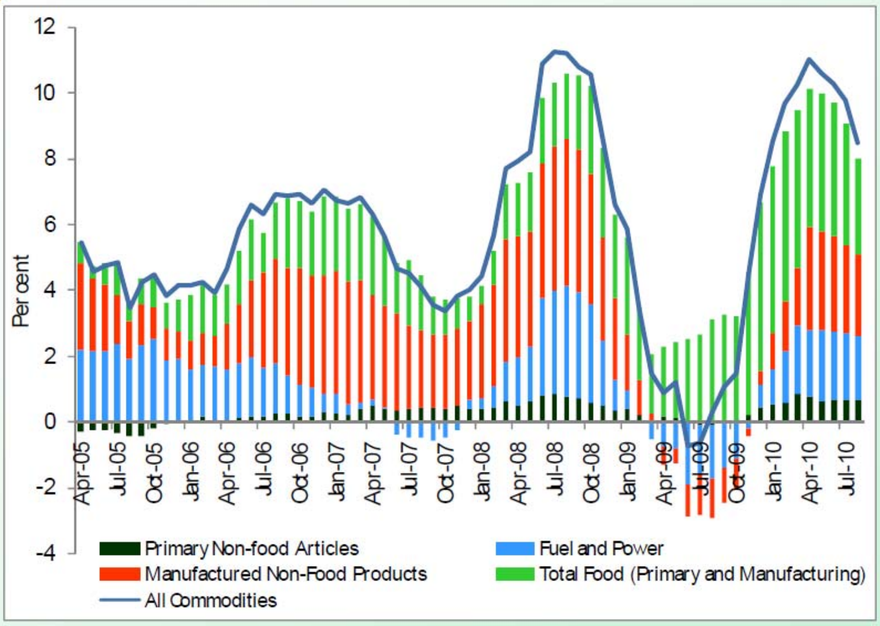
Slide 4: Drivers of Recent Inflation



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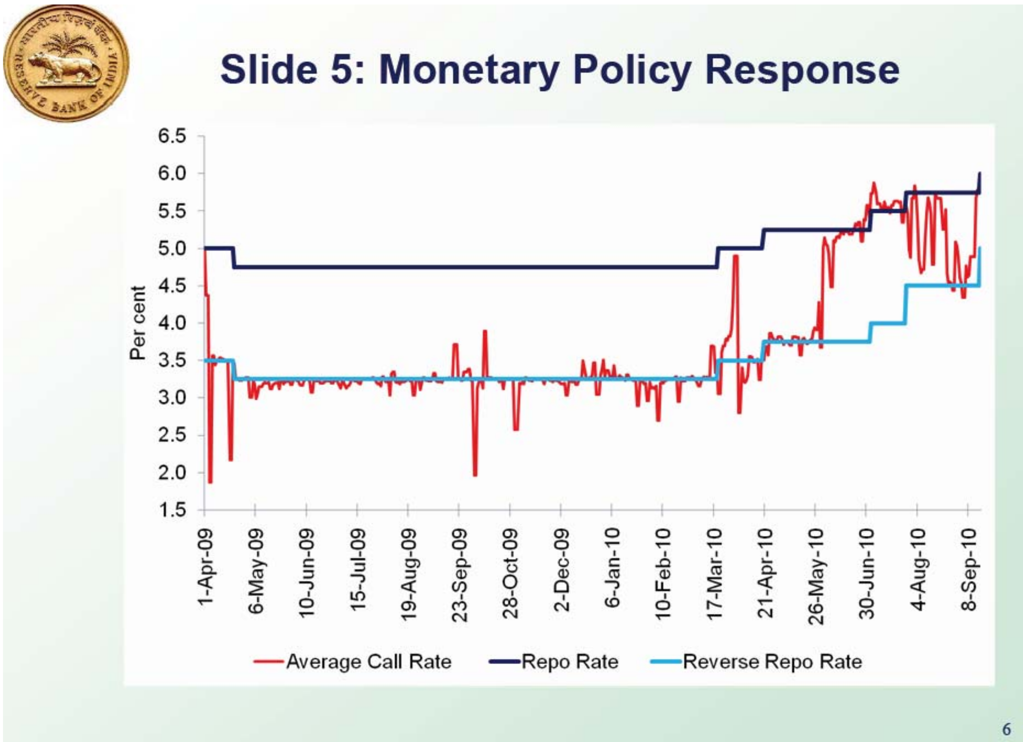
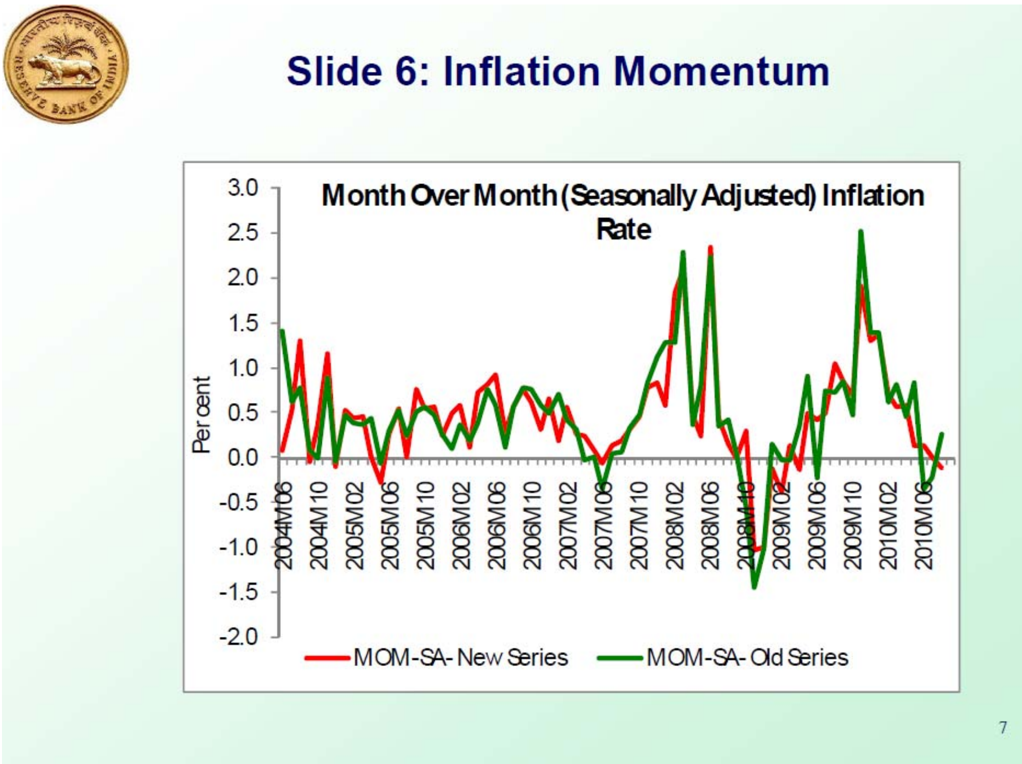
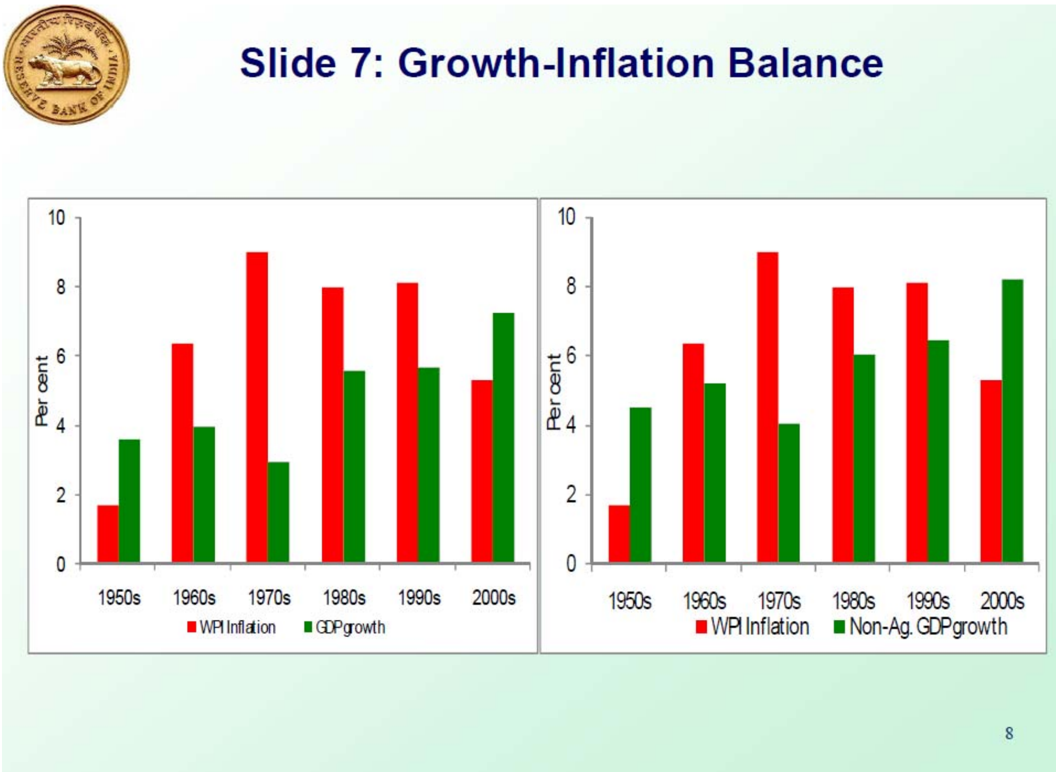
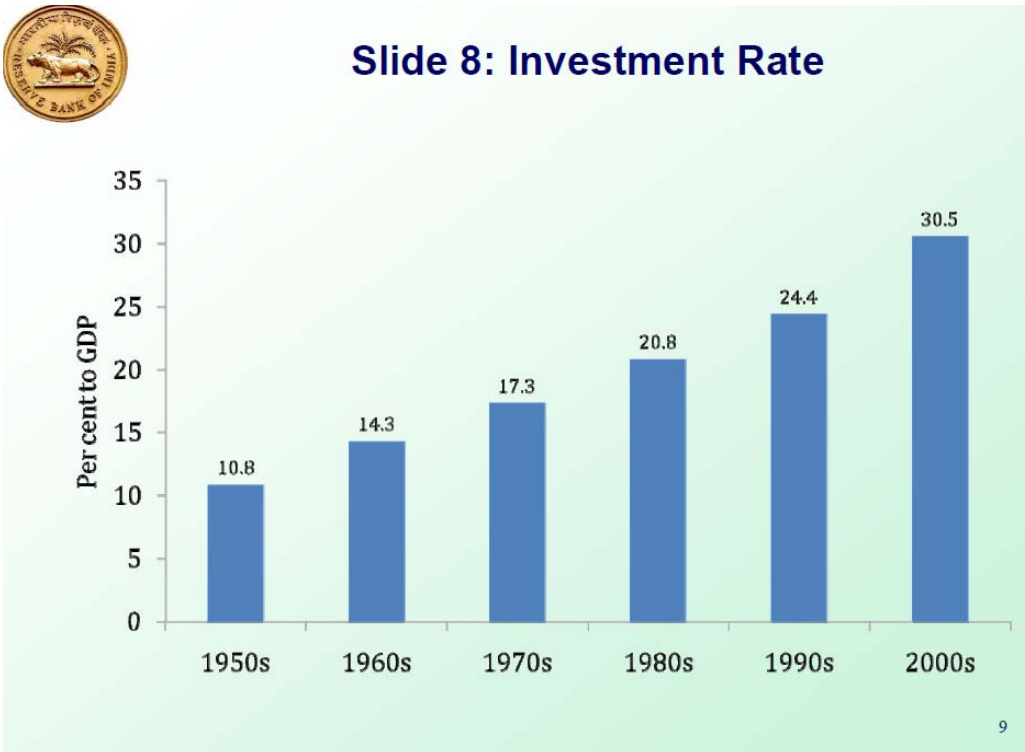
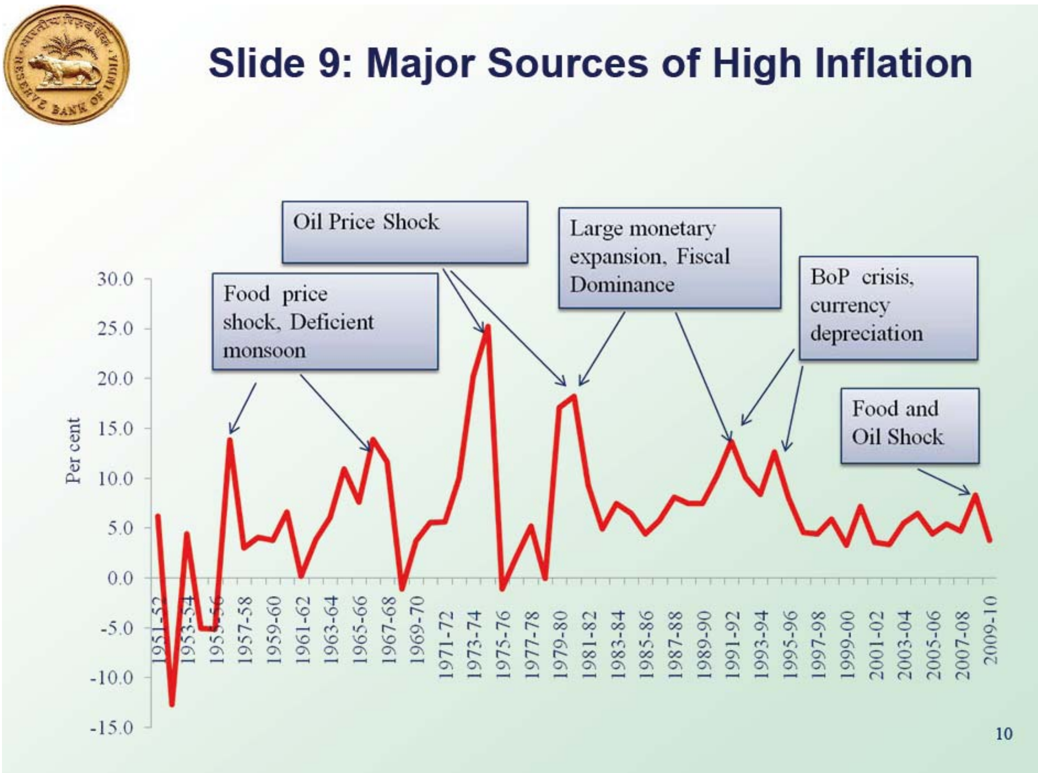
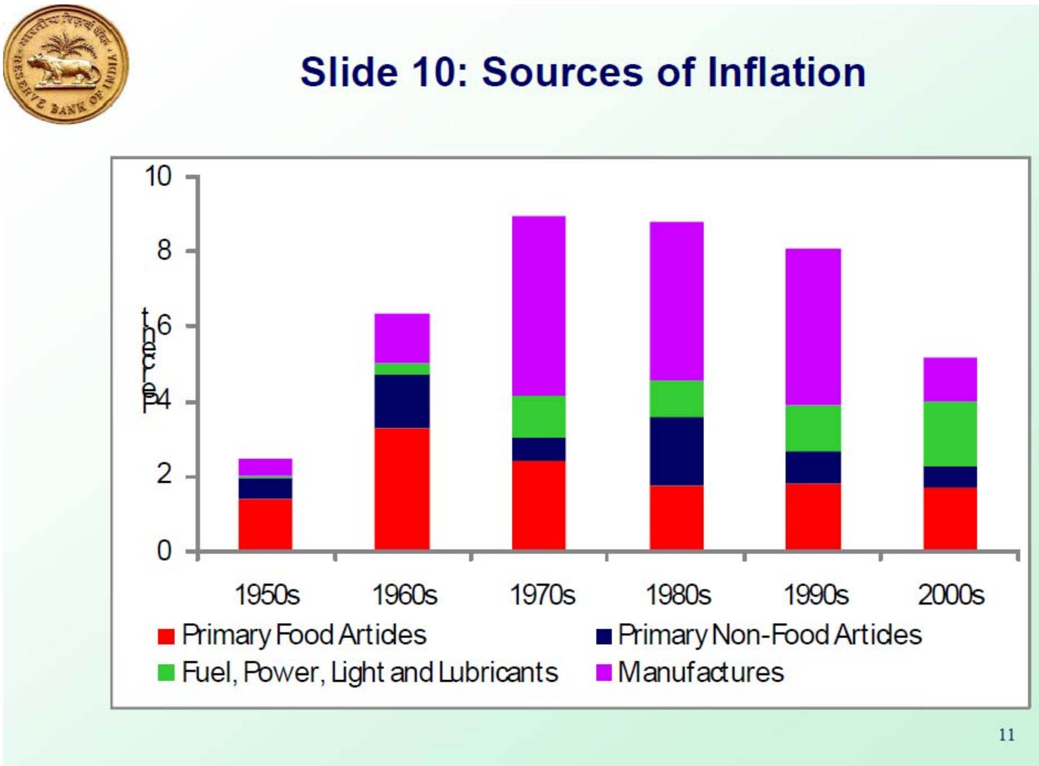

Slide 5: Monetary Policy Response
Per cent
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1-Apr-09
6-May-09
10-Jun-09
15-Jul-09
19-Aug-09
23-Sep-09
28-Oct-09
2-Dec-09
6-Jan-10
10-Feb-10
17-Mar-10
21-Apr-10
26-May-10
30-Jun-10
4-Aug-10
8-Sep-10
Average Call Rate
Repo Rate
Reverse Repo Rate
6

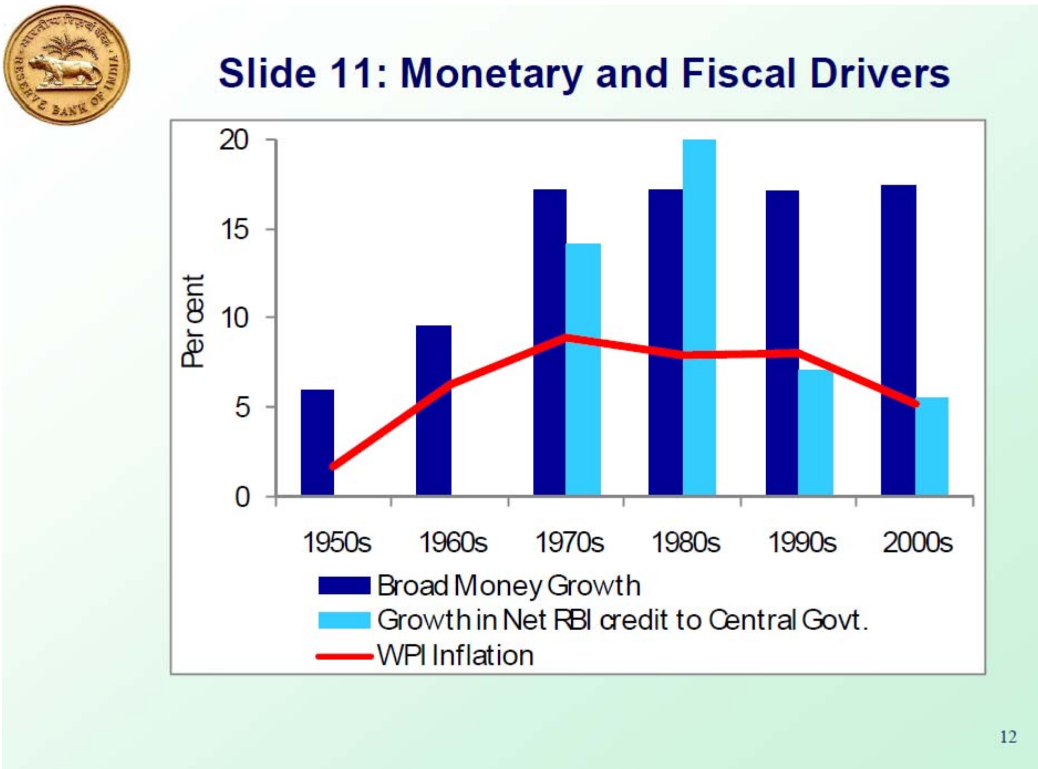

Slide 6: Inflation Momentum
Month Over Month (Seasonally Adjusted) Inflation Rate
Per cent
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
2004M06
2004M10
2005M02
2005M06
2005M10
2006M02
2006M06
2006M10
2007M02
2007M06
2007M10
2008M02
2008M06
2008M10
2009M02
2009M06
2009M10
2010M02
2010M06
MOM-SA-New Series
MOM-SA-Old Series
7

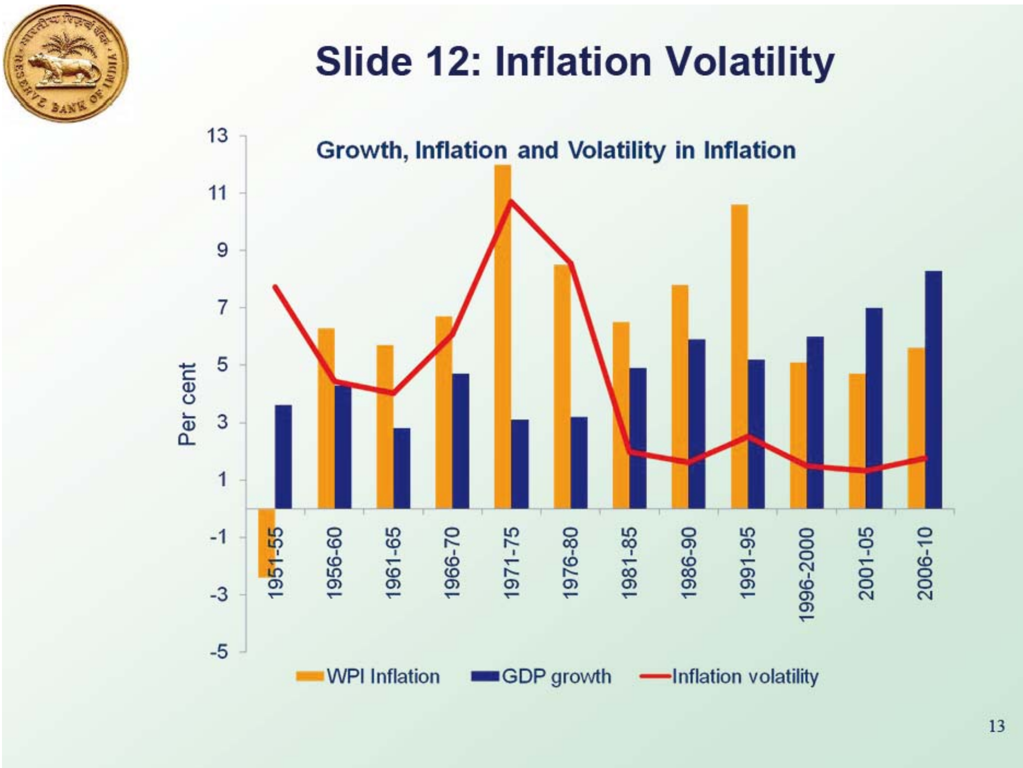

Slide 7: Growth-Inflation Balance
10
8
6
4
2
0
Per cent
1950s
1960s
1970s
1980s
1990s
2000s
WPI Inflation
GDP growth
Non-Ag. GDP growth
8

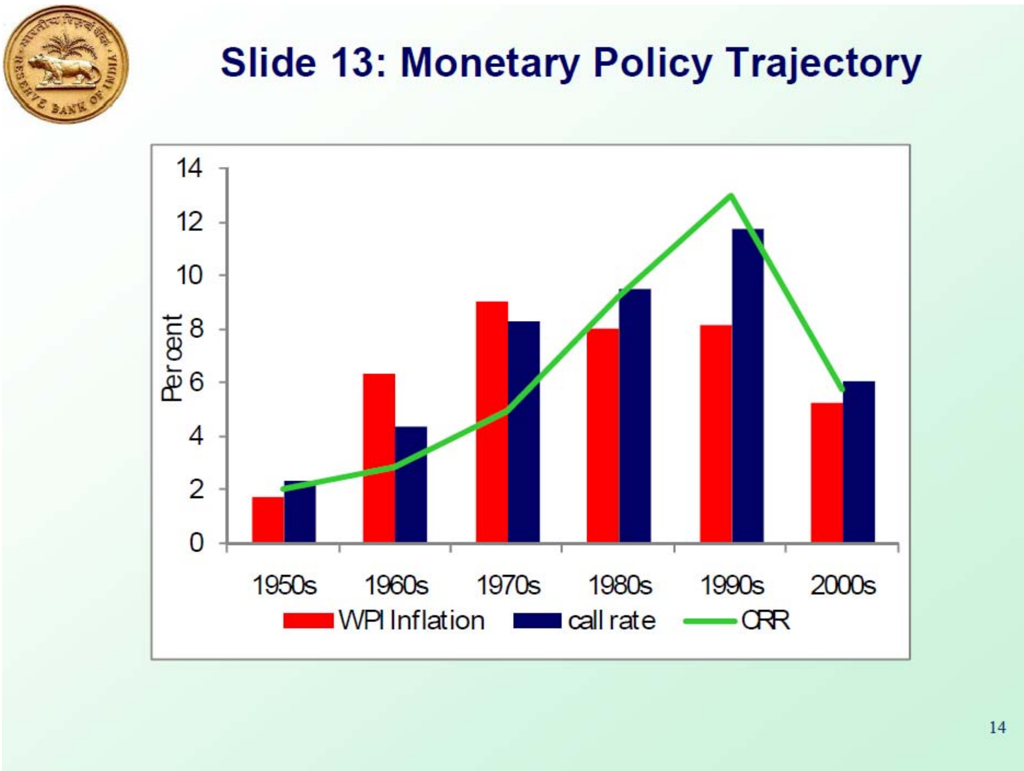

Slide 8: Investment Rate
Per cent to GDP
35
30
25
20
15
10
5
0
10.8
14.3
17.3
20.8
24.4
30.5
1950s
1960s
1970s
1980s
1990s
2000s
9


Slide 9: Major Sources of High Inflation
Oil Price Shock
Food price shock, Deficient monsoon
Large monetary expansion, Fiscal Dominance
BoP crisis, currency depreciation
Food and Oil Shock
Per cent
10


Slide 10: Sources of Inflation
1950s
1960s
1970s
1980s
1990s
2000s
Primary Food Articles
Primary Non-Food Articles
Fuel, Power, Light and Lubricants
Manufactures
11


Slide 11: Monetary and Fiscal Drivers
Per cent
20
15
10
5
0
1950s
1960s
1970s
1980s
1990s
2000s
Broad Money Growth
Growth in Net RBI credit to Central Govt.
WPI Inflation
12


Slide 12: Inflation Volatility
Growth, Inflation and Volatility in Inflation
Per cent
13
11
9
7
5
3
1
-1
-3
-5
1951-55
1956-60
1961-65
1966-70
1971-75
1976-80
1981-85
1986-90
1991-95
1996-2000
2001-05
2006-10
WPI Inflation
GDP growth
Inflation volatility
13


Slide 13: Monetary Policy Trajectory
14
12
10
8
6
4
2
0
Percent
1950s
1960s
1970s
1980s
1990s
2000s
WPI Inflation
call rate
CRR
14