The Guv's Trade-Off

The central bank cannot curb inflation without slowing down the economy. But the question is, by how much? If he hits the brakes too hard the economy could stall. By Rishi Joshi

Treading a tightrope: RBI Governor Y.V. Reddy

A worried prime minister Manmohan Singh recently wrote to all the chief ministers urging them to keep a check on the prices of essential commodities and sought their personal intervention to stem the price rise and ensure adequate supplies of essential commodities to consumers. Clearly, inflation has become a hot potato for the ruling establishment. Despite a slew of fiscal and monetary measures announced by the government and RBI recently, the inflation rate calculated on the basis of the Wholesale Price Index (WPI) has obdurately stayed above 6 per cent levels, against the 5-5.5 per cent inflation target set by the Reserve Bank of India (RBI) for 2006-07.

So what is stoking these figures? The Asian Development Bank (ADB), in its latest annual report, emphasises that agricultural stagnation is a key structural challenge in India and rising food prices have been significant contributors to inflation. It adds that two years of above-trend growth in manufacturing and construction has resulted in massive demand for credit, making it difficult to control money supply.

FIGHTING INFLATION
The government and RBI have moved on several fronts to tackle inflation.

» Government permits zero duty import of wheat and pulses; exports also banned
» Ban of futures trading in tur, urad, rice and wheat
» Ban on milk powder exports
» Prices of petrol and diesel lowered on the back of softening global prices
» Import duties on cooking oils, steel, aluminium, copper, cement and chemicals cut
» RBI hikes repo and reverse repo rates twice, by 175 and 125 basis points, since September 2004
» RBI hikes CRR thrice in four months (in December 2006, February and March 2007) by 50 basis points each

In food production, supply side bottlenecks persist, impacting prices. Foodgrain production in India has stagnated over the last several years even as consumption has gone up. Last year, for instance, a shortage of pulses resulted in prices soaring almost 30 per cent. Wheat prices have also soared 50 per cent on the back of a domestic supply crunch. Points out Surjit Bhalla, MD, Oxus Research: "Last year, even as stocks of wheat went down, there was a drought in wheat producing nations like Australia, Canada, the us and China. So, international prices of wheat went up almost 20-25 per cent."

There may be some relief round the corner, but the rain gods will have to oblige. Says Subir Gokarn, Chief Economist, Crisil: "While the rabi wheat crop is expected to be good, prices will depend on the quality of the harvest. Pulses will be sown only in June and July. Our outlook is that inflation will moderate if the monsoons are normal." But, cautions R. Seshasayee, President, CII: "The agriculture sector needs a complete overhaul. Demand-supply mismatches will be perpetuated if we do not address the situation."

Meanwhile, a cornered government, under pressure from allies, particularly the Left, is busy firefighting and has resorted to drastic measures to rein in farm prices. It has banned futures trading in rice and wheat following an earlier ban on futures trading in tur and urad. Besides, petrol and diesel prices have been lowered twice on the back of softening international prices; wheat exports were banned in February; private traders were allowed to import wheat at zero duty and customs duty on pulses imports has been slashed to zero.

Some economists, however, feel the government is losing sight of the bigger picture. Says Bhalla: "Last year, inflation was stoked by high international prices of wheat and oil. The latter has a high weightage in the inflation basket. Since those conditions don't exist now you'll find the WPI inflation rate gradually stabilising."

Meanwhile, manufacturing inflation, too, is at a high of almost 6.5 per cent. Says Bimal Jalan, former Governor, RBI: "Manufacturing inflation is clearly a case of overheating. Rapid production increases in the last three years have led to capacity constraints. This is unavoidable." Inflation is particularly high in those industries where input costs have risen sharply. Like basic metals, alloys and metal products that depend on imported base metals like nickel and zinc, are also feeling the pinch. Says Marut Sen Gupta, Head, Economic Policy, CII: "Proposals for new investments are pending clearances with various government departments. If that process is fast-tracked, you'll see swift capacity additions."

"RBI is right. Even if it slows growth, it is preferable to high growth with high inflation"
Bimal Jalan
Former Governor, RBI

The government on its part has been trying to be proactive. It has cut import duties on cooking oils, steel, aluminium, copper, cement and chemicals and Finance Minister P. Chidambaram has promised more measures to check prices.

Then, the RBI has begun to tighten its monetary policy. It has hiked the Cash Reserve Ratio (CRR) by 50 basis points each in December and February and sucked out an estimated Rs 27,500 crore from the banking system. There's more: the central bank has announced a third CRR hike of 50 basis points, along with an immediate 25 basis points increase in the repo rate in April. This will take the CRR to 6.5 per cent and drain the banking system of another Rs 15,500 crore. Says Jalan: "The RBI is on the right track. Even if it slows growth marginally, it is preferable to high growth with high inflation as the latter benefits no one."

Experts believe that the RBI move is likely to arrest inflation and bring it down to below 6 per cent possibly with slightly lower rates of growth. ADB estimates that the India economy is poised for a "soft landing" with growth rates of 8 per cent and inflation at 5 per cent. Most people-industrialists, executives, economists and the Congress' aam aadmi-will take that.