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Why monetary policy will not work? PREMIUM

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Rate hikes cannot curb consumption and price rise, if these are more than offset by a price increase in food and fuel items due to a host of factors. The net result, in fact, is a lower real interest rate.

BY NILANJAN BANIK

Come September 17, and Reserve Bank of India (RBI) will have a mid-quarterly review of monetary policy to take stock of the current liquidity scenario and inflation. This meeting has gained relevance after Thursday's hike in diesel price by Rs 5 a litre and the cap on the use of subsidised cooking gas to six cylinders per year. Will this undermine RBI efforts to control inflation?

From a layman's perspective, inflation means rise in price of essential commodities. In the parlance of economics, price of any item rises when there is more demand relative to supply. Managing inflation, therefore, amounts to managing the demand of the product experiencing a rise in prices, or by increasing the supply of this item. In case of managing recession exactly opposite chain of events should take place.

Before we go into how effective RBI has been in managing inflation, it is important to know what constitutes these demand and supply-side factors.

Among demand-side factors, consumption expenditure is important. In India, consumption expenditures contribute close to 65 per cent of our Gross Domestic Product (GDP). The other components are private investment expenditures, government expenditures and trade.

The RBI can only be successful in controlling inflation if the rise in interest rate (read, repo and reverse-repo rates) reduces consumption, private investment and government expenditure.

FOR RBI MOVES TO WORK

Three important assumptions are necessary for RBI intervention to be successful. First, there has to be a perfect pass-through in terms of the change in repo rate and reverse-repo rate leading to a corresponding change in lending rates of commercial banks.

However, in reality, the pass-through is not perfect, and happens with a lag. Second, if prices rise more than proportionately in spite of RBI increasing nominal interest rates, it implies a fall in the real rate of interest.

This is likely to happen with government partially deregulating diesel prices, considered an intermediate input. Therefore, an increase in nominal interest rate may not check increase in aggregate demand, as real interest rate has fallen.

Therefore, an important assumption for a nominal interest rate increase to be effective is price stickiness, which does not hold true, except perhaps for fuel and power items in the short-run.

The third and most important assumption is reduction in consumption, which also depends on the types of goods we are consuming. If the goods consumed are income-inelastic, or where consumers do not care about price of goods consumed, then a rise in interest rate will not reduce demand.

It is to be noted that price of primary commodities and fuel items – something we must necessarily consume – has risen by around 13 per cent during the last three years. This figure would have been much higher with total de-control of diesel, gas, petroleum, and kerosene prices.

Recent Wholesale Price Index data reveals that food items have a total weight of 24.3 per cent --14.3 per cent for 'primary' items such as cereals (4 per cent); eggs, meat and fish (2.4 per cent); and milk (3.3 per cent); and 10 per cent for manufactured food items such as potato chips. The other major items of consumption are fuel and power (15 per cent) and chemical and chemical products (12 per cent).

These are the items the consumer will consume, irrespective of change in prices, especially when income is increasing.

The price rise in essentials shows up in a high level of general prices because of the high weights of these items in the price index.

The price rise offsets the subdued prices of metals such as copper, iron and aluminum.

SUPPLY CONSTRAINTS

Is it only demand-side factors which are fuelling inflation? Inflation can also occur due to short-supply of essential consumption items. For instance, there has been a major reduction in food crop acreage. Measured in terms of lakh hectares, acreage for rice, coarse cereals, pulses, and oil seeds, have fallen by 10.79, 11.63, 2.09, and 2.23 lakh hectares, respectively, in 2011-12 over 2010-11.

Farmers complain they do not get adequate labour to undertake farming activities, thanks to schemes such as Pradhan Mantri Gram Sadak Yojana (PMGSY) and Mahatma Gandhi National Rural Employment Guarantee Scheme Act (MGNREGA). To hire workers, farmers have to shell out anything between Rs 180 and Rs 300 per day, the rate varying from State to State.

The shortage is likely to continue with the implementation of the Food Security Bill. This Bill when passed will entitle 67 per cent of the Indian population to food at a highly subsidised rate, with 7 kg per person per month to below poverty line households, and 3 kg per person per month to the general category households.

Middlemen, instead of procuring foodgrains from the farmers, will now start procuring directly from the Public Distribution System.

This will further dampen the realised price for the farmers, and hence the incentive for farming. As a result of this legislation, cost to the Exchequer will rise to Rs 1.18 lakh crore.

Over last one decade, the annual growth of our agriculture output has been less than 3 per cent. This year, below-normal rain could bring that growth rate down, with around 55 per cent of our agricultural produce dependent on rainfall.

Lower agriculture produce also means higher fodder prices for livestock, leading to increase in price of meat, eggs, and milk.

Capacity constraints in the form of lack storage facilities and an imperfect market due to lack of reforms in the APMC Act have also contributed to price rise in India.

With so many factors at work, it appears that RBI is fighting a losing battle against inflation, with little support from the government.

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