POLICY BRIEF

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Taming Inflation

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Global inflation has been escalating since the start of 2021 which has become a major concern for policymakers across economies. The worldwide economic slowdown and surging prices, aggravated due to Russia and Ukraine war, have worsened global economic prospects at a time when economies were recuperating from the pandemic-induced supply-demand imbalances. The economic consequences, visible in the commodity market, trade, and financial linkages, are retarding growth and escalating inflation further (IMF, 2022). Food, fuel, and fertilizer prices have surged globally affecting the vulnerable population, especially in low- and middle-income countries (LMIC).

Against this backdrop, this analytical policy brief may help to identify timely and robust policy actions to tame inflation. Specifically, we try to answer:

1. What lessons India can learn from global experiences and their policy practices to tame inflation?
2. What are the plausible measures to control and stabilize surging inflation, especially food inflation, without trading off the growth revival of the economy?

Global scenario of inflation

The IMF's World Economic Outlook (July 2022) forecasts global growth at 3.2% and 2.9% for 2022 and 2023 respectively, much lower than the 2021 level (6.1%). At the same time, inflation has remained higher than earlier forecasts, in both developed and developing nations. For instance, inflation for Turkey was recorded at 80.2% and Euro Area at 9.1% (for August 2022), whereas inflation for Brazil, UK and USA stood at 10.1%, 10.1% and 8.5% respectively for July 2022 (Figure 1). Nevertheless, Asian countries like Japan, China, and Vietnam registered retail inflation within the range of 2-3% year-on-year (y-o-y). However, given Japan's history of disinflation, even its current 2.6% inflation is at its highest level since October 2014. Comparatively, India's inflation is projected to be 6.7% (RBI) in 2022-23—not dramatically different from its historic average of 6.4% (2000-19 period) (World Bank, 2022)—although rising inflation has become a matter of significant concern for the Indian policymakers.

Figure 1: Inflation vis-à-vis GDP growth in major countries

Source: Trading Economics and International Monetary Fund and WEO (July, 2022) (Computed using the latest data available)
Note: Inflation and growth in some countries such as Turkey (80.2, 4.0), Sri Lanka (64.3, 2.6), Ethiopia (33.5, 3.8), Pakistan (27.3, 6.0), and Russia (15.1, -6.0) are outliers. Growth data for Singapore, Bangladesh, Ethiopia, Switzerland and Vietnam are based on WEO, April 2022

Similarly, food price inflation, after a long period of stability, has surged across economies irrespective of their level of development. The Food and Agriculture Organization (FAO)'s food price index, is at 140.7 points in July 2022, registering inflation of 13.0% y-o-y (FAO, 2022). In the United States and the Euro Area, food inflation has been continuously on the rise since June 2021 and is at 10.9% and 11.5% respectively, while food inflation in India is at 6.75% as of July 2022.

Drivers of global inflation

At the onset of the pandemic, stringent measures like lockdown and mobility restrictions were unavoidable but these actions had detrimental effect on the economies worldwide. The initial impact of the pandemic originated from first order supply bottlenecks through decline in labour supply as labourers in the non-essential industries were unable to continue work. This led to reduction in wages and income which in the second order led to a fall in aggregate demand (Estupinan et al, 2020).

To revive employment and the slowdown in growth, governments across countries adopted expansionary fiscal measures in the form of guarantees, grants, tax reliefs, tax deferrals, equity participation and public loans (Figures 2). An aggregate of $16.9 trillion in fiscal measures was undertaken globally to restore the losses incurred by the economies during the pandemic. These were accompanied by policy rate cuts by major central banks worldwide during the pandemic (Figure 3). These Keynesian measures were successful in reviving the economies worldwide with growth rates increasing from around -3.1% to 6.1% between 2020 and 2021.

Figure 2: Broad fiscal stimulus in 2020 as % of 2019 GDP

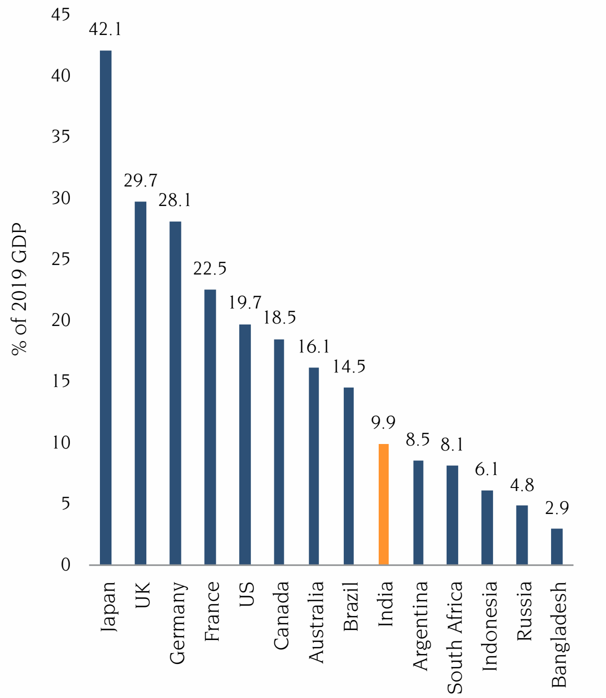
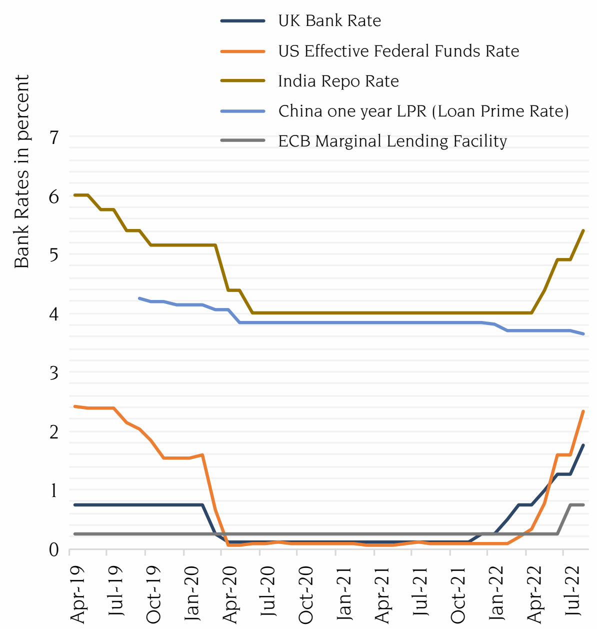


Figure 3: Monetary policy responses, Apr'19- Aug'22



Source: Tracking Economic and Financial Policies During COVID-19 database (2022); Bank rates are from central bank websites of respective countries

However, these expansionary macroeconomic policy stances, combined with lingering supply chain constraints, created excess liquidity in the system with 'too much money chasing too few goods', resulting in a sustained rise in prices. The overwhelming emphasis on these expansionary policies to further growth momentum led to a wider than expected fiscal deficit (Figure 4).

Further negative spill over from the Russia and Ukraine war has aggravated the surge in prices of several commodities as both these economies hold a significant share in world production and export of various agricultural commodities namely wheat, corn, barley, sunflower seeds, and sunflower oil as well as fossil fuels such as oil and natural gas and fertilizers. Disruptions in trade of these essential commodities are fuelling a spike in prices, globally. Moreover, structural factors like economic sanctions imposed by EU and USA on Russia, and elevated production costs due to decarbonization have further added to the price rise.

Major central banks across the globe are focussing on curbing inflation through monetary tightening and policy rates are being brought back to their pre-covid level to absorb excess liquidity from the system. For instance, US Fed increased policy rates by 200 basis points (bps) since April this year and is likely to increase more in the coming months. Likewise, the European Central Bank (ECB) has raised interest rates by 50 bps and hinted about more hikes to bring back inflation to 2% of the target level. The hikes in interest rates in these advanced countries are making other emerging markets less attractive to foreign investors, resulting in the increase of outflows from their bond and equity market. This is leading to, inter-alia, the depreciation of their currencies, worsening the inflationary situation and macro management of the fiscal deficit. For example, between April 2020 and July 2022, the Indian rupee depreciated by 6% with respect to US dollar (Figure 5). A faster depreciation of currency inevitably puts higher pressure on domestic inflation, which in turn may not be favourable for overall growth.

Figure 4: Fiscal deficit in 2021 as % of GDP

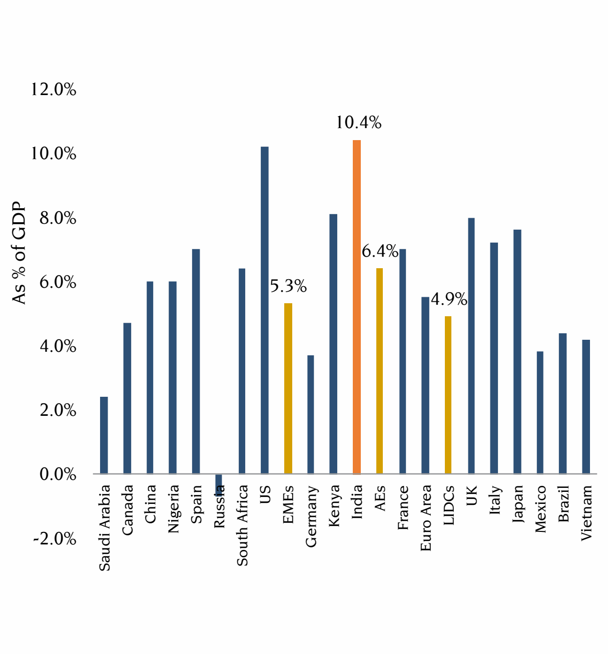
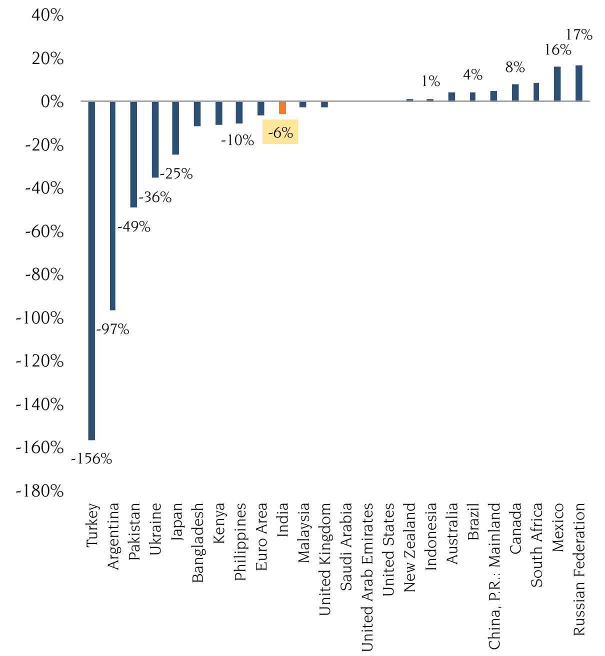


Figure 5: Percentage change in currency rate from Apr'20 to July'22



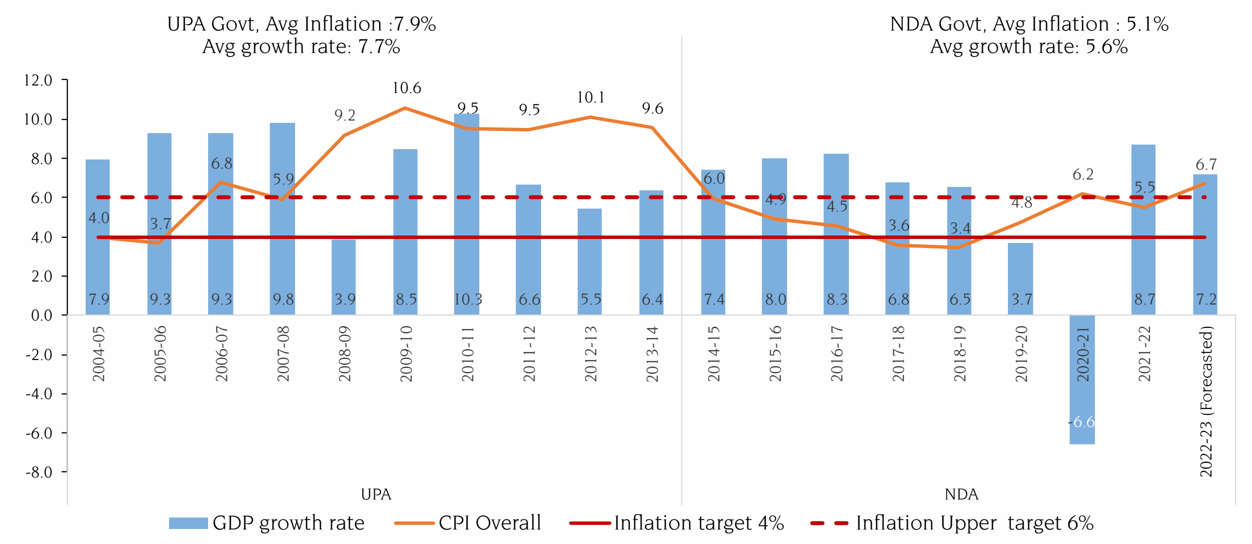
Source: IMF *Fiscal Monitor April* 2022; IMF *International Financial Statistics* (2022). *Note*: AE – *Advanced Economies*, EMDEs – *Emerging market and developing economies*, LIDCs – *Low income developing countries*.

The upshot of all this is that inflationary pressures may not be fully tamed by monetary policy alone. The policymakers also have to work on fiscal policy and watch what is happening to the currency valuation of the country. It is not a simple and straightforward policy choice. It needs calibration and navigating through the complexities of monetary policy, fiscal policy, exchange rate management, and trade policies.

Inflation in India

Like other emerging markets and developing economies, India has also been experiencing inflationary pressures persistently since the beginning of financial year (FY) 2022. India's retail inflation measured using the consumer price index was reported at 7.01% in June which came down to 6.71% in July 2022. However, it has still breached the Reserve Bank of India (RBI)'s upper tolerance level of 6% and has been above the level for the past seven consecutive months. The central bank, under the flexible inflation targeting (FIT) framework, has the task of maintaining a medium-term inflation target of 4%, with a band of +/- 2%. Albeit, for 2022-23, the RBI has recognised that inflation will remain above the upper tolerance level and therefore, revised the projected headline inflation upwards from 4.5% in February to 6.7% in August 2022. At the same time, GDP growth has been projected to be 7.2% for 2022-23 (see Figure 6).

Figure 6: Trend of CPI annual inflation y-o-y% along with GDP growth rate



Source: MoSPI and Office of Economic Advisor, MoCI
Note: For FY 2023, we have used RBI projections.

What are the drivers of inflation in India?

Segregating domestic retail inflation across major groups shows that 'food and beverages' along with 'fuel and light' together constituted close to 60% of CPI inflation in July 2022 (Figure 7). Food and beverages constitute 45.9% of the CPI basket and within that, the consumer food price index (CFPI) constitutes 39.06%. This is in contrast to many advanced economies where food weights are much lower, for instance, UK (9.3%), US (13.2%), Canada (15.94%) and Germany (8.5%). In July'22, food inflation (CFPI) in India registered some moderation and was reported as 6.75% (y-o-y), especially with the softening of edible oil prices coupled with deflation in pulses and eggs.

Figure 7: Contribution of major groups to CPI inflation July'22

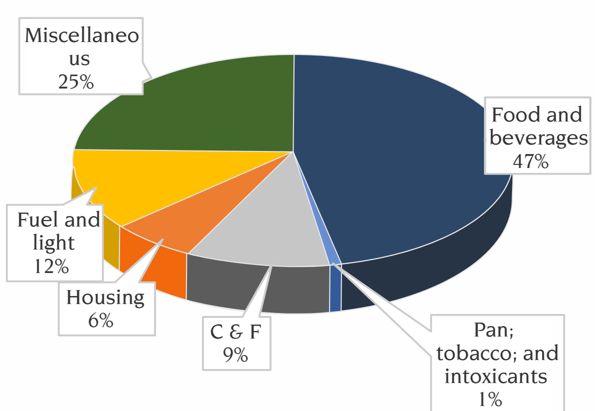
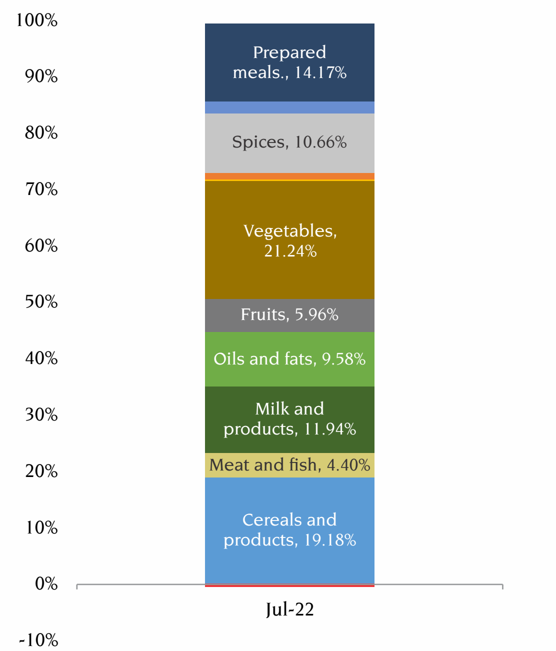


Figure 8: Contribution of sub groups to food and beverages inflation July'22



Source: Authors' calculations using data from MoSPI
Note: C&F is clothing and footwear, Misc.-miscellaneous

Based on the contribution to the food and beverages inflation for July 2022, the major drivers were vegetables (21.24%), followed by cereals and products (19.2%), prepared meals (14.2%), milk and products (11.9%), spices (10.7%) and oil and fat (9.6%) (Figure 8).

Within vegetables, tomatoes registered the highest retail inflation of 44.2% and 158.4% (y-o-y) in July and June 2022, respectively. Tomato prices like other perishables, follow price production cobweb where low price realization in one period forces farmers to shift acreage in the next period to other crops as witnessed in many states last year, which led to lower availability and unprecedented inflation. Besides tomatoes, other vegetables that are under inflationary pressure are potato (33.86%) and cabbage (35.08%) in July 2022.

Cereals and products, with the highest weight in the CFPI basket, also witnessed high price pressure of 6.90% in July'22. Within this, wheat registered the highest inflation at 11.7% in July 2022 (y-o-y) primarily due to a marginal fall in production (about 2.4%) and a significant drop in procurement (more than 50%) over last year. As a result, the government abruptly prohibited wheat export on May 13th and later, wheat flour on Aug 25th, 2022 citing food security concerns as well as inflationary pressure. Another factor that may impact the cereal price outlook somewhat adversely is the drop in rice area in some states where rainfall has been scanty, although rice stocks in FCI are way above the buffer norms.

In the case of oils and fats, inflation is largely imported, as the country's 55-60% of the edible oil demand is met through imports. The price hike in edible oil due to geopolitical tension and resultant supply disruptions, and the impulsive export ban on crude palm oil by Indonesia (which was lifted later on) transmitted to domestic edible oil prices which recorded inflation of 18.8% (oil and fats y-o-y) in March 2022. Recently, global edible oil prices have fallen and India slashed its import duties, which together helped soften domestic edible oil and fats inflation in the country (7.52% in July 2022), providing relief to consumers and policymakers.

Among non-food groups, fuel and light registered inflation of 11.8% in July 2022 with kerosene – PDS contributing the highest (8.4%) to CPI inflation. In June, fuel inflation in India moved back to double digits primarily due to the rise in LPG and kerosene prices. This is because the central government has removed subsidy on kerosene sold through PDS which is now priced at market rates. Additionally, the global crude brent prices are hovering around USD108.92/barrel with inflation of 46% y-o-y in July 2022. Not just that, the recent volatility in the currency with the rupee depreciating against US dollar, could further spur imported inflation. However, India's deal with Russia to get crude at 30 percent discount has helped to soften this blow (Bloomberg, 2022).

Clothing and footwear together registered high inflationary pressure (9.9%) in July 2022. Higher input costs especially of raw cotton and yarn were responsible for the price surge in clothing. Between January 2021 to July 2022, Cotton A-index increased by 50% according to the World Bank. During the same period, the WPI inflation for cotton yarn averaged at 21% in India.

Lastly, recent reports of the uneven spatial distribution of rainfall especially in north-eastern and eastern states may impact kharif production, adding to inflationary pressure. For instance, Uttar Pradesh, Bihar, and Jharkhand have received deficient rainfall of 44%, 38%, and 27% respectively compared to normal (as on Sept 1, 2022).

What policy lessons India can learn from the global experience? And what short- and medium-term measures can be adopted to contain surging inflation, especially food inflation?

One of the short-term policy measures that major central banks of advanced economies are adopting to absorb excess liquidity is monetary tightening. Even RBI has relied on removing excess money supply and therefore, has hiked the policy rate, for the third time in a year, raising the repo rate by 140 basis points to 5.4% between May and August 2022, above the pre-pandemic level. However, these short-term policy measures of the central banks may not be enough to contain food inflation. Higher the weightage of food in overall CPI, the more cumbersome is for monetary policy to contain inflation, as is the case in India. Importantly, the structure of headline inflation in India is quite different from the advanced economies which limits the efficacy of monetary policy in India. This corroborates the urgency to revise CPI with the latest consumption survey weights.

Second, fiscal consolidation along with monetary tightening is equally important to tame inflation. During the pandemic, the Indian government spent a large sum on food and fertilizer subsidy along with various other sops such as corporate tax concessions which resulted in increasing the fiscal deficit to 14% in 2020-21 (including centre and state). While the government expects the centre's fiscal deficit to be 6.4% of GDP for 2022-23 in India, it is unlikely that this targeted level will be maintained unless tax and other revenues of the Union government improve substantially. Therefore, a roadmap for fiscal consolidation should be undertaken by optimising and containing expenditures on populist measures while augmenting capital expenditures on developing basic infrastructure that can help create more jobs in the country.

Third, a prudent policy to curb global inflation would be liberalising the trade policy across economies. In contrast, protectionist trade measures were adopted such as Russia's export restriction on wheat, Indonesia's ban on palm oil exports (which was lifted later on), Argentina's ban on beef export as well as Turkey, Kyrgyzstan, Kazakhstan, and India's ban on a variety of grain products. These trade restrictions, in the wake of a sudden spike in global prices and supply-side shocks, added to the global inflationary spiral. Rather than an outright export ban, a better solution would be to filter exports through a gradual process of minimum export prices and transparent export duties for short durations in India (Gulati, 2022). Additionally, rationalising the import regime through a reduction in tariffs and duties across the board is crucial. For instance, as mentioned earlier, inflation in edible oil has been very high. To correct that, India has reduced the effective duty on crude palm oil (from 44% on January 1st, 2019 to 8.25% in Dec 2021 to 5.5 % in February 2022) and made crude soybean oil, and sunflower oil duty-free (subject to 2 MMT tariff rate quota till FY 2024). However, the import duty on rapeseed and cottonseed oil still remains high at 38.5% for crude and 49.5% for refined.

In the medium to long term, policy measures need to focus on various supply-side bottlenecks, especially in food items which could be managed by increasing productivity by investing in research and development in agriculture. Additionally, to tame inflation in perishables, linking their value chain to processing capacity, can act as buffer stock for the lean season.

Rising inflationary pressure is a major concern for policymakers as it directly affects household purchasing power. Therefore, prompt and appropriate policy stances to tame inflation is all the more crucial, else resurgence of inflation will continue to reinforce inequality, both within and across countries. To protect the vulnerable population, India has done commendably well in providing free foodgrains (10 kg per person) to 800 million people for more than two years under Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY) besides some cash transfers.

The shocks to global and local economies may keep coming from extreme events (like heat waves, floods, droughts, etc.) resulting from climate change, or even bigger conflicts among some nations, and therefore, policymakers need to be on the alert and ready for quick decision making depending upon what the situation demands. India has done fairly well in containing inflation, especially compared to its developed world peers, and hopefully can do better whenever the need arises.

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