ACHIEVING DURABLE INFLATION

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One of the major objectives of Government of India and the Reserve Bank of India is achieving durable inflation. Inflation in India had reached 10-11 percent in 2008 and remained elevated for several years. Over the past 3 years, inflation has come down from 9.4 percent in 2013 to 5.9 percent in 2014 to 4.9 percent in 2015 to a projected value of 4.7 percent in 2017. There has been a persistent demand for lowering policy rates. The dilemma is low policy rates are not possible with low inflation. The paper seeks to explore the challenges for RBI to lower policy rates.

The increase in inflation from 2008-13 coincided with rapidly rising food and commodity prices. Food prices rose sharply from 2008 and by the end of 2013 had nearly doubled compared to 2007 prices. Food inflation was the key driver of India's high and persistent inflation. Further, international commodity prices exert an important influence on India's inflation. The fuel component of the wholesale price index moves with the international commodity prices.

There are several consequences of high inflation. The conventional view was that high inflation affects growth, and persistently high inflation above a certain threshold level can be a drag on economic growth. Economic research has shown that there exists a statistically significant negative long term relationship between inflation and economic growth in India. Significant inflation-growth threshold effects have been observed in cases of inflation rates above 5.5 percent. The average growth is higher in States where the inflation was below 5.5 percent and a statistically significant negative effect of inflation on long term growth was visible where inflation was higher than 5.5 percent.

Inflation hurts middle class and poor households quite significantly. Middle class households confronted with high inflation bring forward their purchases of clothing, appliances, houseware or other products in the consumption basket. The consumption basket of the poor is disproportionately focused on food which cannot be brought forward because of its perishability. In a 2014 working paper, the IMF said with food inflation remaining persistently high for five years, monetary policy needs to remain tight to control generalized inflation. Given the elevated and persistent inflation, the RBI may need to raise rates to tackle inflation durably, particularly if faced with a persistent and sizable supply-side food price shock putting pressure on broad-based

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inflation. As inflation is mostly backward looking, monetary policy has to maintain a tight stance for a prolonged period of time.

The RBI was historically reluctant to lock itself into an inflation-focused framework is because of the dominance of fiscal policy over monetary policy in the Indian context. The possibility of fiscal dominance, however, only means that if the government overspends, the central bank has to compensate with tighter policy to achieve the inflation objective. The RBI has further held the view that since food and fuel account for more than 57 percent of the CPI on which the direct influence of monetary policy is limited, the commitment to the nominal anchor would need to be demonstrated by timely monetary policy response to risks from second round effects and inflation expectations in response to shocks to food and fuel.

Since 2014, the Government of India took several steps to rein in food inflation. The minimum support prices for key agricultural commodities were increased. Government released additional food grains from the Central Pool into the market. Government further notified that buffers norms of these food grains to levels significantly below prevailing actual stocks. These measures have helped lower cereal (rice and wheat) inflation.

In their 2017 Article IV consultations, the IMF has said that India's CPI inflation is expected to remain contained in the near term, but inflationary pressures are set to rise in the second half of 2017. With temporary demand disruptions and increased monsoon-driven food supplies, CPI inflation is expected at about 4 ¾ percent by early 2017, in line with the RBI inflation target of 5 percent by March 2017. However, inflationary pressures are likely to reappear in the second half of 2017, in part reflecting government pay reviews and the waning effects of the oil price collapse. Upside risks to inflation stem from supply-side factors, such as volatility of agricultural prices, including due to possible smaller harvests as a result of cash shortages inhibiting purchases of agricultural inputs.

To conclude it can be said that inflation and growth are two sides of the same coin. The RBI sets policy rates as low as it can, consistent with meeting the inflation objectives. The transition to a low inflation economy requires sustained fiscal policy support. India is on the path to building the institutions necessary to secure a low inflation future. The Government has taken the momentous step of amending the RBI Act to provide for a statutory and institutionalized monetary policy committee for maintaining price stability while keeping in mind the objective of growth. The MPC has been entrusted with the task of fixing the benchmark policy rate required to contain inflation within the specified target level. For the period, 2016-2021, Government has notified the inflation target as 4 percent with an upper tolerance level of 6 percent and lower tolerance level of 2 percent.

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