CRITICAL ISSUES RELATING TO RISING PRICES

S.S. BHANDARE

FORUM OF FREE ENTERPRISE
PIRAMAL MANSION, 235 DR. D. N. ROAD.
BOMBAY 400 001.

"Free Enterprise was born with man and shall survive as long as man survives".

-A.D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

CRITICAL ISSUES RELATING TO RISING PRICES

By

S.S. BHANDARE*

The Indian planning experience of the last over four and a half decades is typically one of rising prices. Between 1950-51 and 1994-95, the Wholesale Price Index (WPI), which is commonly used for measuring inflation, increased by over 16.5 times or at an annual compound rate of 6.6%. Out of 45 years, since the beginning of planning, there have been only five years during which prices showed some actual fall. Of these five years, it may be relevant to mention that three years occurred during the First Plan phase itself.

If we recognise the phenomenon of relative price-stability as one involving price rise of not more than 5% a year -- even with this level of inflation, Prof. Vakil might have been worried -- then only in eleven years, the price rise could be restrained within this limit. Thus, out of 45 years of planned development, there were 16 years during which the management of the Indian price situation was

** The author is Economic Adviser, Tata Services Ltd. The text is based upon the keynote address delivered at a seminar on "Rising Prices" arranged in Bombay on 12th August 1995 as a tribute to the late Prof. C.N. Vakil, eminent economist, and whose birth centenary is being celebrated during 1995. The views expressed are author's personal.

generally satisfactory and efficient. In other words, almost twothirds of the period of our tryst with economic planning is characterised by high and continuously rising prices. As a matter of fact, India experienced several strong bouts of inflation during this period; in **13** out of **45** years, the inflation rate crossed the dangerous limit of double-digit level.

Very recently, Lord Meghnad Desai delivering Prof. C.N. Vakil Birth Centenary Year lecture, observed that there is "a basic inflation-aversion of the Indian society". Lord Desai characterised the Indian experience as one of low inflation. This is certainly based on his perception of the international experience wherein a number of Latin American and African countries have gone through not double digit, but treble or even quadruple digit inflation. He pointed out that historically speaking, India too experienced a high level of inflation during the two World War periods. Further, he seemed to be appreciative of the fact that India is one of the few developing countries in the world to witness double-digit inflation on a few occasions during the post-independence period. He argued that the shocks experienced by the Indian society due to these phases of high inflation have created a strong resistance to high inflation through the political process.

Rising prices by themselves may not be cause for much concern. But rising prices accompanied by relatively

low economic growth and accentuation of skewed income distribution pose a major threat not only to economic, but **also** to political stability. This is a dangerous combination for dealin'g with the problem of poverty, and a powerful threat to employment generation in the country. Since the reduction of poverty is unquestionably the most critical and complex developmental challenges one can ignore the problem of rising prices at great peril to the political economy of the country. The international experience as well as research on poverty in India, all conclusively suggest that inflation affects the poor most adversely.

A Word About Causative Factors

Having said this, it would be futile on my part to deal with the theoretical or analytical framework of causative factors of the Indian inflationary scenario, on which there are already different schools of thought. Suffice it to say, debates among the monetarists and the structuralists continue to be endless and inconclusive on this subject. Incidentally, while it would be improper to place any specific label on the varied contributions of Prof. Vakil, one tends to believe that he was a monetarist to the core.

Taking recourse to the logic of conventional analysis, however, it can be said that over a long period, there is a consistent contribution of both (a) demand-pull and (b) cost-push factors to the Indian inflationary phenomenon. The distinction between demand-pull inflation and cost-push inflation is to a great extent a mirror reflection of monetarist and structuralist view points. It is no doubt useful for the purpose of fine-tuning of the policy prescriptions, but in due course it must be recognised that one set of forces tends to merge with the other.

In simple terms, inflation attributable to the pull of demand is triggered off by factors like : (i) rapid increases in the government expenditure, (ii) excessive money supply growth, (iii) income increases, (iv) population growth, (v) changes in the pattern of income distribution, (vi) black money generation, (vii) speculation and hoarding, (vii) spread of consumerism or conspicuous consumption and so on. Essentially, in the analysis of demand-pull factors, the focus is on rapid growth of aggregate demand without a proportionate change in supply of various goods and services in the economy.

In contrast, the cost-push pressures are essentially generated by either the wage-price spiral or pressures created through increases in the cost of raw materials, intermediates and capital goods. The cost-push factors emanate from structural rigidities in production, inadequate supply responses and constraints on productivity and efficiency improvements. The character of inflation keeps on changing from time to time. But, the Indian experience so far suggests that inflation has been predominantly of the demand-pull type.

Turning To The Critical Questions

It is against this backdrop, one is compelled to raise

certain critical questions particularly, when, to use the usual cliche, India is **at** the cross-roads of her economic reforms process. To recall briefly, the two essential components of reforms launched in July 1991 are :

(i) the macro-economic stabilisation with emphasis on fiscal consolidation; and

(ii) the structural adjustment policies aiming at promotion of liberalisation, competition and globalisation of the economy.

While, the Finance Minister, Dr. Manmohan Singh deserves all the accolades for the magnificent initial thrust of reforms, and the prioritisation and logical sequencing of various policy initiatives, one must express disappointment at the present state and fate of reforms. We still have on hand an enormous unfinished agenda of our economic reforms, and all that carries a vital bearing on the problem of rising prices. Already, the experience of the first four years of reforms shows that on the basis of conventional norms, there has been a large inflationary gap in the economy, reflected in high actual level of inflation. (Appendix I).

How to Resolve the Trade-off Between Growth and Inflation

Coming to specific questions : we cannot avoid raising first and foremost, the debate with respect to the trade-off between growth and inflation. There invariably is a see-saw battle of these conflicting goals of economic policies. Thus, it is pertinent to debate whether a thrust on acceleration of growth always jeopardises the relative price stability. In contrast, does anti-inflationary policy always defeat the objective of growth promotion? The recent article in **The Economist** observes that "Economists have spent a lot of effort trying to measure the effect of inflation on economic growth. Many governments would be grateful for clear evidence that it slows growth lot; this would make it easier for them to justify the usually painful policies that are needed to bring inflation down. But the evidence, such as it is, is none too clear."

However, **this trade-off debate in** India **seems to be overwhelmingly biased on sacrificing growth for the sake of scoring some gains In terms of softening the rate of inflation.** In this context, one may venture to propose a **choice between the two alternatives.** The first alternative concerns with achieving relative price stability (inflation of upto 5%) together with the prospects of relatively low overall GDP growth of, say, 4 percent. The second alternative would obviously aim at accelerated GDP growth rate to, say, 7% accompanied by the inflation rate in the range of 8 to 9%. Surely, I believe that it would be difficult to reach any consensus on this aspect.

But for the sake of argument if it is possible **to develop a workable model of development that combines the second alternative of high growth with relatively high inflation, and simultaneously seeks the prospects of sharing at least 50% of gains of growth with 40% of the people below the poverty line,** would this not be a preferable option rather than being destined to achieve the Hindu growth rate of 3.5 percent? One must readily admit that what is proposed is too simplistic; indeed, there are no serious pretensions in our proposal to combine the three complex parameters, namely (i) high growth rate, (ii) moderately high inflation, and (iii) mechanism for devolving atleast 50% of the gains of growth amongst the poor and the deprived sections of the community.

But, one needs to look into this aspect more carefully since we are **probing the future inflationary scenario in India.** The purpose of stressing this point is that keeping in view various inflationary factors operating in the Indian economy, **there is no hope for the Indian economy, securing, at least in the coming decade, the relative price stability, involving rate of inflation of not more than, say, 5% per annum.** One can say this with a definite degree of confidence on the basis of some key macro and micro factors elaborated subsequently.

It may be all right for the matured economies like the USA, Germany, Japan, U.K. etc., having reached high standards of living, to resolve the trade off between growth and inflation by making a decision choice in favour of reining in inflation at 2 to 3 percent. But, most of these economies did experience relatively high inflation in the range of 6-9% per annum even during the seventies.

Likewise, the so-called East-Asian miracle economies like South Korea, Taiwan, Singapore, Hong Kong, and now Malaysia, Indonesia and Thailand, have had high rates of inflation during the seventies, but accompanied by very high levels of overall **GDP** growth rate. It is only in the last few years, that the East-Asian countries are witnessing moderation in their inflation rate, and simultaneously, are achieving high GDP growth rates.

It appears that in the drive towards acceleration of GDP growth rate at the present stage of our economic development and standards of living, we may have to pay some price in terms of relatively high inflation rate. For quite some time, therefore, the question to be debated is : How to evolve our development strategy for the next 10 years, in which, while accelerating the **GDP** growth rate to, say, 7% (and this is imperative in case we really want to make a decisive impact of the twin problem of poverty and unemployment), there may be a need felt for compromising, but only partially, the goal of rigid control of inflation? Obviously, the objective of this proposition is not to think in terms of having a double-digit inflation, but restraining it in the range of 7 to 8 percent.

Implications of Restrictive Fiscal Policy

The second important question that logically follows is: how long will it take for us to bring about fiscal consolidation, which is, indeed, the condition precedent

in the successful management of the current economic reforms? It is well-known that after the initial success of reducing the fiscal deficit to **GDP** ratio **(FDR)** of the Central Government from 8.4% in 1990-91 to 5.7% in 1992-93, there has been a major slippage during 1993-94 and 1994-95, when this ratio turned out to be higher at ***7.7%*** and **6.7%,** respectively, exceeding the budget estimates. (Appendix II). The gains in the management of FDR so far have been made possible on account of (i) some restraint in the growth of subsidies and defence expenditure, (ii) sybstantial slowing down in the growth of plan expenditure and (iii) transferring increasingly the responsibility of plan financing from the budget to the public sector undertakings (PSUs).

What stands out in this strategy of fiscal consolidation so far, is an overwhelming stress on reduction in the budgetary allocations to plan, and in particular to the PSUs. Thus, the budgetary support to Central Plan, which had already declined from 80.5% in 1980-81 to 51.1% in 1990-91, dropped further to 40.9% in 1994-95. Given the fiscal imperatives of the Central Government, one would tend to support such a strategy, but we cannot ignore the threat it poses to the achievement of physical targets, particularly in the critical infrastructure areas. Given the prevailing scenario of private sector response and major gaps still persisting in our policies and approach to infrastructure development, it would be quite some years for the private sector to replace the existing dominant role of the public sector in this area.

Equally important, most of the PSUs have yet to go through the process of managerial, organisational and financial restructuring. No doubt, the logic of fiscal reforms demands the PSUs should be made self-reliant not only with respect to their needs of resource-raising, but also in their organisational and management matters. This would also facilitate their vigorous privatisation subsequently to support the cause of prudent fiscal management. But in the meantime, the prospects of **infrastructural** inadequacies do not augur well both from the point of view of growth of the economy and controlling inflation.

Managing the Revenue Deficits

The third and the most important question relates to the manner in which both the Centre and the States are coming to deal with the problem of managing their revenue deficits. It is not relevant at this stage to evaluate the specific causes of this problem. Suffice it to say, the phenomenon of mounting revenue deficit is due to the consistent divergence in the growth of revenue expenditure and revenue receipts. Thus, in the case of Central Government, while the annual compound growth rate of revenue expenditure works out to 14.3% during the decade ending 1995-96, revenue receipts are growing at the rate of only 13.1%.

If the same trend rate in the growth of revenue expenditure and revenue receipts is allowed to continue, by the end of 2001 the extent of revenue

deficit of the Central Government would expand from the anticipated level of Rs.35,541 crores in 1995-96 to as much as Rs.79,443 crores. At this level of revenue deficit, the Central government perhaps would have virtually nothing to spare for undertaking any worthwhile programmes of plan expenditure. Even if it is proposed to cap the revenue deficit at the present level, we need to expand revenue receipts at the rate of 18% per annum for the next 5 years, while keeping the revenue expenditure growth at the present level of 14%. Therefore, when experts tend to suggest that it is of utmost necessity for the Central Government to eliminate revenue deficit as soon as possible, the clear dimension of the task involved does not seem to be easily appreciated.

Undoubtedly, the restraint on the growth of revenue expenditure would not only call for rationalisation of subsidies and restraint on defence expenditure, but also control on interest payments and administrative expenditure. Unfortunately, nothing significant seems to be happening in any of these areas. One may, therefore, propose that the government would at least seek to halve the present size of revenue deficit by 2001. This is not an impossible proposition. It would involve holding under tight leash the growth of revenue expenditure to about 12% per annum and increasing the revenue receipts to about 18%. But for this to be achieved, there is an urgency of a restrictive fiscal policy, the specific components of which need to be debated.

But, surely, the government cannot afford to sacrifice any revenues both tax and nontax. Thus, even in the area of taxation, there may be scope for further refinement and rationalization, but not for any immediate reduction in the incidence of taxation. In fact, the government needs to evaluate the non-orthodox means of raising revenues, as the private corporate sector is doing in the area of 'other income', for example by relocating offices and offering such office premises, especially in metropolitan cities, at fabulous rentals.

At this stage, one is also compelled to suggest the need for a comprehensive appraisal of all areas of committed expenditure particularly, on administration both at the Central and the States' level. In this context, it may be recalled that sometime in 1966, the Government of India had set up the Administrative Reforms Commission with very wide ranging terms of reference. But those days were the halcyon days of ever-expanding role of Government and commanding heights of the public sector in economic activities. Obviously, the focus then was to strenthen regulations and controls. There is now a change; it is now an era of liberalisation and competition. Already significant industrial and import licensing reforms are effected, but there is no corresponding rethinking on reduction and restructuring of the bureaucracy.

Urgency of Raising Savings Ratio

The fourth important issue to be debated is : How to

raise our savings ratio? This point becomes relevant for debate since, in our approach, we are laying stress on the urgency of acceleration of GDP growth. Once again, it is also important to highlight that persistent massive fiscal deficits of both Central and State governments are gobbling up a large part of the investible resources of the economy. Large fiscal deficits by themselves may not be harmful if funds were to be directed towards productive capital formation in the economy. Such capital expenditure could atleast hold promise of generating income flows and savings in the subsequent stages.

What is happening instead is a massive diversion of investment resources, as mentioned earlier, in finding the revenue deficit. This is causing permanent damage to the capacity of the economy to generate both a stream of income and savings potential. Even during the short span of the last five years, the ratio of revenue deficit to gross savings of the economy has risen from about 15% in 1989-90 to over 22% in 1994-95. The present size of the revenue deficits works out to roughly 4.6% of GDP. In other words, as suggested earlier, even if modest efforts are made to halve the revenue deficit, our savings ratio can increase by **atleast** about **2.3% of GDP.**

What is required, of course, is to step up our savings ratio as the Finance Minister has been repeatedly pointing out, to **atleast 28-30%** of GDP. It is this level of savings ratio that can facilitate the achievement of GDP target of 7% on a sustained basis. However, the failure to enhance the savings ratio would mean a shortage of credit and capital in the economy; it would result in maintaining the present high interest rates and thereby, also contribute towards cost push pressures in the economy. We have to find effective ways of reducing revenue deficit, which would therefore contribute to public sector savings straight-away. Simultaneously, in the quest for simplification of the tax system, we cannot ignore the imperatives of providing incentives both to the private corporate and household sector to expand their capacity to save. It would not be beyond the ingenuity of our fiscal experts to evolve specific incentives, which are revenue-neutral in their impact, but generate greater incremental savings.

Emphasis on Productivity Growth

The fifth important issue to be debated is how to improve the productivity of the economy. It is not that the growth of savings alone which can contribute to improvement in the growth performance of the economy, but also the emphasis on productivity standards. It is well-known that the organised manufacturing sector in India went through a long spell of decline in total factor productivity during 1960 to 1980. This is what the famous study of Dr. (Mrs.) Isher Judge Ahluwalia showed. But even with some early liberalisation of industrial policy in the decade of the eighties, there was an improvement in industrial productivity. Perhaps, with the on-going

process of economic reforms, one can visualise the prospects of sustaining such improvement in productivity. To some extent, there is already evidence of this happening from the recent studies bringing out improvement in capacity utilisation of industries and in consumption standards of critical inputs like energy.

What is also necessary is to improve productivity of the agricultural sector. In case of India, despite two green revolutions, the yields per hectare of our principal crops are still significantly low in international comparisons. Illustratively, in the case of wheat India is the third largest producer in the world, but her yield per hectare is 2,320 kg. as aginst 7,250 kg. in U.K., 6,480 kg in France and 3,440 kg. in China. Likewise, in the case of cotton, India is the third largest producer in the world, but her yield per hectare is 290 kg. as against 1,560 kg. in Australia, 750 kg. in China, 680 kg. in USA and 500 kg. in Pakistan. One can cite various other figures of similar poor yield levels in other major crops. The point to be emphasised is that unless the agricultural productivity improves further, not only the growth of the economy cannot be sustained at high levels, but also the prospects of moderating inflation through increasing supplies of wage-goods are going to be remote.

Wage Goods Availability And Prices

Finally, our debate on rising prices would be incomplete without reference to the status of availability of wage goods and their prevailing high prices. Prof. C.N. Vakil placed wage goods at the centre-stage of his developmental strategy, which had price stability as the principal objective. The official data suggests that almost all the major wage goods witnessed significant improvement in terms of per capita availability in the last four decades. For example, the per capita net availability per day of cereals was 373 grams in 1955, but by 1994 it increased to 436 grams. Likewise, in the case of several other products the per capita annual availability increased, for example, in the case of edible oils from 2.5 kg. in 1955-56 to 6 kg. in 1993-94, sugar from 5 kg. to 12.4 kg., tea from 362 grams to 620 grams and cloth from about 15 meters to 25.8 meters.

Interestingly enough, despite such improvements in the availability of these commodities, on the basis of official WPI data, the prices of most of these items have risen faster than those of other commodities. Thus, with 1981-82=100, the quarterly WPI for April-June 1995 in the case of all-commodities is 289, while in the case of foodgrains it is higher at 307, edible oils 300, cotton textiles 317 and so on. Prices of many other wage goods like pulses, vegetables, milk, coffee, etc. are also on a much higher side as compared to the overall WPI. The question, therefore, is not only one of raising production of wage goods, but also of ensuring their efficient distribution at reasonable prices. It is in this context, several issues like the role of administered prices

of foodgrains, sugar, kerosene, etc., management of public distribution system, including its coverage and subsidies, efficient deployment of massive foodgrain stocks, etc. invite a fresh look and directives.

Summing Up

The problem of rising prices will continue to dominate the Indian economic scene for several years to come. There is, indeed, a very valid perception that in the post-reforms period, whatever may be the gains achieved in terms of industrial growth, resurgence of investment, improvement in balance of payments, etc. the problem of double-digit inflation has remained with us continuously for a period of last four years.

It is this concern about rising prices in the post-reforms period that has motivated us to raise an important debate on the trade-off between growth and inflation. This is so because it seems that rapid growth with price stability will continue to be an elusive goal. Surely to score a real victory in this area calls for restoration of fiscal discipline; it calls for stepping up the savings ratio; it calls for improving productivity; it calls for expanding production of wage goods and moderating their prices; and so on. Indeed, all these and many other related tasks find their reflection in the perceptive contributions of Prof. Vakil from time to time. Let us then pay our tributes to him by rededicating our commitment to war on rising prices, but at the same time not forgetting the urgency of accelerating

economic growth. Otherwise, the story of decline and fall of the Indian economy in the international league table will continue even as we enter the twenty-first century!

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

APPENDIX I

RELATIONSHIP BETWEEN OUTPUT, MONEY SUPPLY AND INFLATION

YEAR	MONEY SUPPLY MARCH END (RS. CRORES)	REAL GDP (RS. CRORES)	AVERAGE W.P.I. (1981-82=100)
1990-91	265,828	212,276	182.7
1991-92	317,049	214,156	207.8
1992-93	366,825	223,438	228.7
1993-94	433,566	233,042	247.8
1994-95	526,478	245,306	274.6

% CHANGE IN

	MONEY SUPPLY	REAL. GDP	INFLATION RATE (%)	INFLATION-ARY GAP (%) (1-2)
1990-91	15.8	5.3	10.3	10.5
1991-92	19.3	0.9	13.7	18.4
1992-93	15.7	4.3	10.0	11.4
1993-94	18.2	4.3	8.4	13.9
1994-95	21.4	5.3	10.8	16.1

APPENDIX II

VARIOUS MEASURES OF CENTRAL GOVT. DEFICITS

(Rs.in Crores)

FISCAL DEFICITS	PROMISE (B.E.)		(R.E.)	PERFORMANCE	ACCOUNTS	
1990-91	36,796	(6.9)	43,331	(8.1)	44,650	(8.3)
1991-92	37,727	(6.1)	37,792	(6.1)	36,325	(5.9)
1992-93	34,408	(4.9)	36,722	(5.2)	40,173	(5.7)
1993-94	36,959	(4.7)	58,551	(7.4)	60,257	(7.7)
1994-95	54,915	(6.0)	61,035	(6.7)	?	?
1995-96	57,634	(5.5)	?	?		
REVENUE DEFICITS						
1990-91	13,032	(2.4)	17,585	(3.3)	18,562	(3.5)
1991-92	13,854	(2.2)	17,081	(2.8)	16,261	(2.6)
1992-93	13,882	(2.0)	16,700	(2.4)	18,574	(2.6)
1993-94	17,630	(2.2)	34,058	(4.3)	32,716	(4.2)
1994-95	32,727	(3.6)	34,132	(3.7)	?	
1995-96	35,541	(3.4)	?	?	?	
BUDGET DEFICITS						
1990-91	7,206	(1.3)	10,772	(2.0)	11,347	(2.1)
1991-92	7,719	(1.3)	7,032	(1.1)	6,855	(1.1)
1992-93	5,389	(0.8)	7,202	(1.0)	12,312	(1.8)
1993-94	4,314	(0.5)	9,060	(1.2)	10,960	(1.4)
1994-95	6,000	(0.7)	6,000	(0.7)	?	
1995-96	5,000	(0.5)	3		?	

(FIGURES IN BRACKETS ARE RATIOS TO GDP AT MARKET PRICES)

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

FORUM OF FREE ENTERPRISE

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual Membership fee is Rs.50/- (entrance fee Rs.50/-) and Associate Membership fee Rs.20/- (entrance fee Rs.10/-). Graduate course students can get our booklets and leaflets by becoming Student Associates on payment of Rs.10/- only (no entrance fee).

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box No.209, Bombay 400 001.

Published by M.R. Pai for the Forum of Free Enterprise,
"Piramal Mansion", 235, Dr. D.N. Road, Bombay 400 001. -
Laser Typesetting by GRAPHTECH, Tel.: 261 7479, 267 8060
and printed at Vijay Printing Press,
9-10, 3rd Floor, Mahalaxmi Industrial Estate,
Gandhi Nagar, Lower Parel, Bombay 400 013.

17 Aug./1995