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Inflation-Should it be Cured or Endured?

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I.G. PATEL

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The R.B.R.R. Kale Memorial Lecture 1982 was delivered by Dr. Indraprasad Gordhanbhai Patel on 21st May 1983 at the Institute. The subject of the lecture was *Inflation - Should it be Cured or Endured?*

Dr. I.G. Patel is currently the Director of the Indian Institute of Management at Ahmedabad. Educated at Baroda and later Cambridge (England) from where he received the degree of Ph.D. in Economics, he worked for a couple of years, 1949-50, as a Professor of Economics at the University of Baroda. He left the University to join the International Monetary Fund where he worked as an Economist and Assistant Chief in the Financial Problems and Policy Division from 1950-54. In 1955 he returned to India to work as the Deputy Economic Adviser in the Ministry of Finance. From 1958 to 1961 he was the Alternate Director for India in the International Monetary Fund. In 1961 he returned to the Finance Ministry to work as the Chief Economic Adviser till 1963, during which period he also worked as Economic Advisor to the Planning Commission. Dr. Patel briefly returned to the University when he was a Visiting Professor at the University of Delhi in 1964. From 1965 to 1967 he worked as Chief Economic Advisor to the Ministry of Finance, and during 1968-72 as the Special Secretary and Secretary, Department of Economic Affairs of the Ministry of Finance. During this period he was also a member of the Atomic Energy Commission. From 1972-77 he worked as the Deputy Administrator of the U.N. Development Programme. He returned to India to become the Governor of the Reserve Bank of India from 1977-1982.

Dr. Patel has published a large number of papers on economic analysis and policy.

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Inflation - Should it be Cured or Endured ?

I. G. Patel

I

INTRODUCTORY

1. May I say at the outset how happy and honoured I feel to have this opportunity to pay my humble tribute to the memory of Shri R.R. Kale, the founder of the Gokhale Institute of Politics and Economics. If ever there was a case where the vision and generosity of the founder have been more than amply rewarded by the success of the institution founded, surely the Gokhale Institute would have the pride of place in claiming that honour. In paying our tribute to the founder, therefore, we are also acknowledging our debt to the institution which has played and continues to play such a vital role in shaping economic thought and policy in the country; and I am sure you would not misunderstand it if I say that for me, on this occasion, it is difficult not to think of Prof. D.R. Gadgil who came to signify for most of us the values that the Servants of India Society stands for, the values of service and sacrifice, of scrupulous scholarship combined with the most dedicated and courageous advocacy of social and political reform, values, in short, of the highest personal integrity matched only by intellectual vigour and an active involvement in the issues of the day.

2. When Professor Rath suggested that I might choose inflation as my subject for this year's Kale Memorial Lecture, I was in two minds. Inflation is obviously one of the more glamorous subjects in economics; and its relevance and appeal are as widespread as they seem to be everlasting. No government in the world, and much less a democratically elected one, can be indifferent to it; and it is for the control of inflation, for example, that the industrially advanced countries seem to be willing to tolerate today unemployment of more than 30 million of their citizens.

* Text of R.R. Kale Memorial Lecture delivered at the Gokhale Institute of Politics and Economics, Pune, on May 21, 1983.

For the developing countries, inflation has had the same kind of fascination as original sin — a temptation that has to be resisted even though it cannot be overcome altogether. The resulting ambivalence has often led to alternative bouts of bold developmental efforts and cautious stabilization policies, which in turn have lent their growth paths a kind of cyclical character. One advantage of talking about inflation, therefore, is that one is almost always relevant.

3. But, by the same token, what can one say on such a perennial subject which can be interesting, let alone new? Most economists have written or spoken about inflation more than once in their life time; and in my case, my first piece of published writing more than thirty years ago was on 'Inflation in Relation to Economic Development'; and I have reverted to this theme on a number of occasions. Professor Rath, however, also provided the rationale for choosing this well-trodden path once again: the very fact that controversy still surrounds this vital area of applied economics justifies at least an active practitioner in the field to do a bit of stock-taking and to try and say where he currently comes out. And with your permission, this is precisely what I propose to do this evening.

4. Let me make at the outset a rather sweeping statement that there is hardly any real difference of opinion about the meaning, causes and even the consequences of inflation. Where economists of different persuasion seem to part company is when it comes to policy prescriptions; and even here, the controversies are not generally about the total universe of policies that are relevant. The clash of opinion is about the relative importance of different anti-inflationary policies and even more, at the bottom, about how effective these policies can be without generating conflicts with other desirable objectives such as growth, employment or equity. The doubts, uncertainty or difference — and at the other extreme, the dogmatism and certitude — are about how far we can carry the battle against inflation without making the cure worse than the disease. That is why I have entitled my talk this evening: Inflation, should it be cured or endured? More correctly, the question that needs to be posed is, how far can inflation be reasonably cured and beyond what point should it be endured and how? The answer will obviously differ from time to time and place to place. But when one is confronted by such a pervasive and potentially pernicious phenomenon as inflation, it is necessary to develop at least certain guidelines for policy as a do nothing or wait and see attitude towards inflation is simply not admissible.

II

MEANING AND CAUSES OF INFLATION

5. About the meaning of inflation, there is certainly not much room for misunderstanding or controversy. Price rises

have to be both generally pervasive and sustained over time before they can be defined as inflationary; and when they are of this nature, they also generate rather strong expectations about further continued rise.

6. The proposition that there is now general agreement on the causes of inflation may perhaps raise some eyebrows. But I believe most economists would agree that inflationary pressures are generated by excess demand or/and by cost-push impulses. Both these explanations or causes could also be subsumed under the common heading of a struggle for a larger share in the national product by one sector which is likely to be resisted by another sector — the struggle sometimes taking the form of excess demand and sometimes of cost-push, but generally ending in price rises which tend to be cumulative and which generate expectations of a further rise. If governments or the private sector try to invest more than what private savers are willing to lend to them at current rates of interest, we get a situation of excess demand which tends to raise prices in general. Similarly, if wage-earners or wheat producers try to increase their share in the national product, they would raise wages and wheat prices by some kind of joint action; and if others in society try to retain their share by raising the price of their product or service by concerted action; we get a struggle waged through competitive price rises which tend to be cumulative.

7. The distinction between excess demand and cost-push is sometimes referred to as the demand-side versus the supply-side of the story — or, even, the macro versus the micro side of the story. This characterisation has certainly some validity. But there are two points that deserve to be noted. One, which has been mentioned, is that for inflationary pressures to continue, no matter how they arise, it is necessary that there is some kind of struggle to retain or/and to enhance the respective shares in total national product. Thus distributional questions are at the very heart of inflation — they explain why inflations arise, why they are likely to be harmful and what has to be borne in mind if anti-inflationary policies are to be successful and are not likely to be carried too far. To talk of inflation without focussing on distribution of income is to speak of Hamlet without the Prince of Denmark. But of this, more later.

8. The second, and seemingly contrary, point is that some supply-side changes or shocks may be purely or largely market-determined in the sense that they reflect changes in market supply and demand and not any arbitrary or artificial exercise of group bargaining power. If the market forces are short-term and likely to be reversed, as in the case of seasonal or even cyclical behaviour of food and raw material prices, it would be legitimate to seek to counter them and to narrow the range of fluctuations. But when the market forces reflect long-term underlying trends, as in

the case of recent secular rise in the price of oil, some change in relative prices has to be allowed to prevail; and it is generally easier to do so by allowing some prices to rise. But it is by no means easy to allow legitimate price rises to take place without generating unwarranted pressures for price rises elsewhere — much less to ensure that a price rise at a desirable point will be compensated by a price decline elsewhere. This distinction between warranted and unwarranted price rises, while clear in theory, cannot equally be made clear to all concerned in practice. And here again lies yet another source of struggle which gives rise to inflation.

9. Some of you are no doubt surprised that I have spoken so much about the causes of inflation without referring to that celebrated economic entity called the quantity of money. The popular and rather picturesque view is that inflation is caused by too much money chasing too few goods; and scholars are not wanting who assign to changes in the quantity of money the pride of place in generating inflation. It is, however, important to emphasise that there is no direct or mystical connection between the quantity of money and the general price level. Nor does the quantity of money change on its own. It changes as a result of other phenomena such as a budget deficit or foreign exchange surplus or expansion in bank credit; and it is these underlying phenomena which are sought to be captured when we speak of excess demand or cost-push or a struggle for a larger share of the national cake. This much, I am sure, would be accepted by the most dogmatic adherent of the monetarist philosophy. What the monetarists or the advocates of the Quantity Theory of Money are really saying is that no matter how an inflationary impulse originates, it cannot result in a sustained rise in prices unless there is an accompanying and accommodating rise in the quantity of money. In this view, causes like ex ante excess demand or cost-push may be necessary but are not sufficient — a change in the quantity of money is also necessary. But let it be noted that it is meaningless to speak of a change in the quantity of money as being a sufficient cause of inflation. As already mentioned, the quantity of money does not and cannot change on its own.

10. The issue is not merely a semantic one or one which can be settled with reference to canons of logic. For, the monetarists who hold that inflation is caused by changes in the quantity of money also hold the reverse to be true, i.e., that inflation can be controlled — and controlled only — by controlling the quantity of money. Herein lies the crux of the most controversies about inflation. Unlike the monetarists, there are many economists — among whom I include myself — who hold that while controlling the supply of money may be necessary, it is not generally sufficient. Control of inflation also requires us to address ourselves directly to the original causes of the struggle between different groups. It requires specifically that we seek to

resolve this struggle by appropriate acts of persuasion and leadership — i.e., by the exercise of the so-called incomes policy. Some of us would go further and add that controlling the supply of money is not as easy as it sounds and, beyond a point, efforts to control money supply at whatever cost are likely in some cases at least, to imply an intolerable sacrifice of desirable objectives other than the control of inflation so that a pragmatic policy cannot be based on a single target. In any event, controlling money supply requires effort on so many fronts that by itself this simplistic prescription does not tell us much about what might need to be done in a given situation. More often than not, changes in the quantity of money can serve only as a kind of rough and ready blood count for gauging the severity or otherwise of the inflationary infection. But a blood count by itself does not tell us much about how to get rid of the infection.

III

THE CONSEQUENCES OF INFLATION

11. As you must have noted, the discussion of causes of inflation inevitably leads to the question of how to cure it. But before I enlarge upon this central part of my lecture this evening, let me say a word about the consequences of inflation about which, in my opinion, there is general agreement by now. There has been a respectable view throughout economic history that a gently rising price-level of one or two per cent per annum could have beneficial effects on savings, investment and growth by so to speak providing some cover against the uncertainty and risk of the future. This is true at any rate as long as the price rise is not anticipated and, therefore, already reflected in interest rates and investment decisions and the like. This view has been held by very respectable and certainly not so radical economists as Professor Jacob Viner and Professor D.H. Robertson. I suspect there are many adherents of this view even today. The trouble is that with the experience of double-digit inflation almost everywhere over the past decade or two, there is little likelihood that inflation of the order of even two per cent per year would not be anticipated. What is more, even if the pace of inflation is brought down to some two per cent per annum, the expectations would be that, in all probability, it would accelerate in future. I would not, therefore, claim in the present circumstances any merit for inflation per se of whatever order. If up to a point it has to be endured, as I believe it has to be, it is as a lesser and necessary evil and not as a desirable thing in itself.

12. In any event, when inflation assumes more serious proportions of say 10 per cent per annum or more, there is no doubt that it has a pervasive and decisive impact on society through distributional changes which are neither fair nor stable nor predictable. When large, frequent and

unpredictable but often perverse changes take place in the distribution of income and wealth, they tend to disrupt the social fabric, create industrial unrest and generally discourage any rational long-term activity such as saving or productive investment. Inflation leads also to an upsurge in speculative tendencies resulting in a sizeable part of investible surpluses getting locked up in less productive investments such as inventories, conspicuous construction, gold, jewellery etc., which are supposed to provide a better hedge against inflation. The sanctity of contracts gets eroded and when the standard and measure of value, viz., money, itself loses its value steadily, it tends to erode other values such as respect for contractual obligations and, generally, for the law of the land itself. This much is now common experience in most countries; and that is why there is general agreement that control of inflation has to be a major objective of all governments, and particularly of all freely elected governments.

IV

CONTROL OF INFLATION

13. But how do we control inflation? Let us, to begin with, go back to the monetarist prescription that no matter how an inflationary impulse arises, it can be prevented from leading to a cumulative rise in prices by controlling the supply of money. Let us assume that, starting from a position of equilibrium, government decides to spend more and increase its deficit (in the sense of its claim on the savings of the rest of the society). In the Indian context where interest rates are determined administratively and not in the market and where the Central Bank is obliged passively to finance all deficits at least of the Central Government, the immediate effect of the budget deficit would be a corresponding increase in money supply in the hands of the public. A large part of the newly created money will tend to be spent giving rise to higher prices (in the absence of excess capacity or increase in productivity). The process will continue until the higher value of goods and services in circulation requires that the higher quantity of money be held for transactions purposes.

14. The same point can also be expressed by saying that price rise will continue till it creates forced savings equal to the original increase in the budget deficit which in this case is also equal to the increase in money supply. The higher budget deficit will be matched to some extent by an increase in savings but also to an extent by reduction in investment elsewhere. If, however, workers and others try to recover their share of consumption or private investors seek to continue their investment by borrowing from banks, there would be another twist to the upward trend in prices. If budget deficits continue at levels signifying excess demand, we will have further fuel added to the inflationary fires.

15. How should a monetarist approach seek to deal with this situation? Obviously, a monetarist would argue that interest rates should be allowed to change freely in response to market forces and the Central Bank should not finance the government. On these assumptions, the government will be forced to increase the rate of interest at which it borrows from the market and this will have an upward impact on all rates of interest. To some extent, this will increase savings and will also curtail private investment and the additional needs of government will be met in part by higher savings and in part by lower private investment. But if, as is likely, total savings are not very interest elastic, the impact on private investment will be severe. How far interest rates will have to rise and how much private investment (or consumption) will have to be curtailed cannot be said with certainty. Since government will have to pay higher interest charges on the entire debt, it is by no means certain that its deficit and borrowing requirements will go down at least to begin with; and if it insists on spending the desired amount and borrowing more, interest rates may reach such heights as to virtually kill-off all private investment causing very high rates of unemployment. Thus, while inflation will be prevented by putting a lid on money supply, the price in terms of unemployment, excess capacity and fixed investment foregone can be excessive.* That this scenario is not a figment of imagination is obvious to any observer of the recent - and indeed current - scene in industrially advanced countries.

16. The moral, of course, is not that we should, in the face of a budget deficit, allow money supply to increase and keep interest rates constant. The moral obviously is that where *fiscal policy* tends to create excess demand, it is no use trying to deal with it by monetary policy alone. *Fiscal problems ought to be handled primarily if not exclusively by fiscal policy.*

17. This is not to deny that the objective of *fiscal policy* itself can often be expressed conveniently in monetary terms. Thus, for example, in India where interest rates are determined administratively at least over a large area and the Central Bank is required to lend full support at least to the central budget, the objective of keeping the budget deficit around a level where it does not lead to excess or deficient demand can also be conveniently expressed in terms of keeping money supply within certain limits set by the growth in production. Indeed the budget deficit itself can be defined, as we do in India, in monetary terms

* Since we have essentially the Indian case in mind, we have not referred to the high interest rates attracting capital movements from abroad as we have rigid controls over such movements. However, where capital movements are free, an increase in the inflow of capital will lead to an appreciation of the exchange rate and this tends also to dampen local activity, investment and employment.

rather than in the savings investment sense.* And a similar analytical and diagnostic treatment can also be given to inflationary pressures arising from an export surplus or an excessive level of private investment. Combining all three, we get an analytical and policy framework in terms of total money-supply or indeed the quantity theory of money; and despite all our intellectual protestations, this indeed is the framework we have followed in India ever since Independence — and have been enjoined to follow from time to time by the International Monetary Fund.

18. The monetary analysis and targets have not always been explicitly stated except in relation to the latest Fund drawing. But they have been generally there at least as internal guide posts; and, often, as in the case of the annual budgets or the five-year plans, there is at least some attempt to make *this monetary-cum-savings-investment approach* to analysis and policy somewhat explicit. I for one consider this approach useful at least in Indian conditions as I do not see much reason or scope for giving up the two related assumptions of administratively determined interest rates and full Central Bank support to the budget. But the usefulness of this approach would depend on how faithfully we adopt it and on our recognition of its limitations. While, as already mentioned earlier, it can serve as an early warning signal and even as a rough and ready gauge of comparative success or failure in controlling inflationary pressures, it can never chart for us the full course of anti-inflationary policies — let alone the full spectrum of economic policies. And on both counts — of faithfulness to the approach and recognising its limitations — our practice in India leaves much to be desired.

19. Consider first the question of following the framework faithfully. Surely, the first requirement of intelligent policy-making is that it should be explicit and open — the two are not always the same. Our definition of a budgetary deficit falls short of measuring the impact on even the narrowest of concepts of money supply. It does not even show the full extent of Central Bank credit to the government. To exclude, as we do, the increase in Central Bank holding of long-term securities from the definition of a budgetary deficit has no justification whatever, particularly when, as has been the case in recent years, there have been sizeable increases in Central Bank holding of government securities. And I would urge that we change our practice forthwith in this regard as policy-makers ultimately succeed in fooling no one except themselves by adopting or continuing to adopt mirrors that distort rather than reflect reality. After all, it would be a miracle if estimates do not go wrong. Why then not include all that is relevant in the estimates as well as the actuals unless the intention is partial concealment? Even this pretext has lost its

* We have here an interesting example of how the relevance of economic theory depends so much on the specific institutional assumptions one makes.

relevance after the recent IMF drawing when most observers at home and abroad have come to expect knowledge about the total money-creating effects of the Government Budget.

20. An explicit and open monetary-cum-savings-investment approach will also require some ex-ante as well as ex-post *apportionment between the different major factors* that are responsible for the change in money supply. This is not just a matter of analytical curiosity. It is obviously essential if the origins of inflationary pressures are to be correctly assessed and remedies applied at the right point. If the excess demand comes from the budget, it is budgetary policy that needs to be corrected. Even if it is desired that other sectors absorb the pressures that come from the Budget, for example, the precise magnitude of how much is sought to be absorbed and how needs to be spelt out. This is why ex-ante determination not only of how much money supply can increase but also of the respective share in the increase of the budget deficit, of increase in foreign exchange reserves and of private credit is of the very essence of anti-inflationary policy — for, as mentioned earlier, distributional changes are at the very heart of inflation. But we do not even begin to understand the process if we talk only in terms of money supply in general.

21. It is perhaps not fair to say that the ex-ante ambiguity about what should be the share of the three factors mentioned in the permissible increase in money supply is a deliberate attempt to obscure the fact that the claims of the budget are given over-riding significance. Part at least of the ambiguity may be explained by imperfections of the data base — imperfections which are quite well-known to anyone who has attempted an even ex-post presentation of the facts. But the result undoubtedly is to create a presumption in favour of appropriating the major if not the *entire scope for money creation for the benefit of the budget*. How else do we explain the fact that the question as to how much of the scope for deficit financing should be reserved for the private sector, was raised explicitly to the best of my knowledge, in only one annual budget of the Centre, viz., that in 1967? Or that in all plans as well as periodic discussions of the scope for budget deficits, credit (for the budget) is taken corresponding to the possible declines in foreign exchange reserves but on no occasion a possible and indeed desirable increase in foreign exchange reserves has been anticipated and reflected per contra in a corresponding reduction in the level of a budgetary deficit? After all, with a growing value of foreign trade and payments, there has to be a growing trend in foreign exchange reserves so that a part of the scope for the expansion of money supply will have to be reserved for the external sector. Or again, how do we explain the fact that when faced by inflationary pressures we have repeatedly ended up by increasing the already high obligation on the part of the commercial banks to subscribe to Government and other approved securities when what ought to be changed, if at all,

is the Cash Reserve Ratio?

22. The oft-repeated charge of the private sector that inflationary pressures arising from the Budget are generally sought to be countered by denying legitimate credit to the private sector may reflect nothing more than a force of habit and there have undoubtedly been occasions when private sector credit also needed to be curbed. Nor do I subscribe to the current fashionable view in the IMF — which in fact goes back some half a century to Colin Clark — that there are some generally valid limits beyond which budgetary deficits or expenditures are bound to be inflationary — irrespective of whether such limits are expressed as the share of the budget in permissible monetary expansion or the percentage that a budget or its deficit suitably defined bears to total GNP. The appropriate shares — however, defined — would vary from country to country and from time to time and the roles assigned to the Government in total investment or total economic activity are obviously relevant factors to be considered. But *nor can the share of the Government be stretched at will at any given time*; and making our assumptions explicit about the share at least of each of the major sectors as their legitimate claim on savings — or for simplicity, in the permissible scope for money creation — has at least this merit that it forces us to think of the several levels at which policy-making has to operate. Once again, it forces us not just to think in aggregative terms but to ask: who is to accommodate whom, by how much, and how — and perhaps also over what period?

23. And this brings me back once again to the *limitations of what I have described as the monetary-cum-savings-investment approach to inflationary pressures*. By far the most prevalent and persistent but pernicious aspect of this approach is that it encourages a *one-step arithmetical approach to policy-making*. Do we have to reduce the budgetary deficit by Rs. X crores? Why, just raise taxes — any taxes — by Rs. X crores, i.e. raise taxes which in a one-step arithmetical manner are supposed to yield an additional tax revenue of Rs. X crores. If indeed you can find some non-tax source of revenue so much the better — for it will not cause any resentment. And, if you can find some windfall or once-in-a-while gain, better still, for it is likely to bite even less. And we can do all this, not only to reduce a potential deficit in one year, but year after year — for, after all, is not the arithmetic of a desirable deficit done each year? Are not our national accounts generally cast in annual terms? In an almost seductive and unnoticed manner, *what is true of small changes made occasionally is assumed to be true of large changes repeatedly made*; what is true of taxes is assumed to be equally true of mobilization of savings; what is true of voluntary savings is assumed to be true of compulsory savings; and what is true of lasting changes is assumed to be equally true of wind-fall or once-for-all changes.

24. That this is not some imaginary scenario can be easily seen by a look at recent history. Sale of Government gold, Trust Fund drawings and Bearer Bonds no doubt have had other justifications, but the immediate impact on reducing budgetary deficits surely did tip the scales somewhat. Fortunately, in our system of accounting, I.M.F. drawings do not result in a reduction in budgetary deficits even as narrowly defined as it is in our case. But can one be sure that such drawings have not or will not cast a shadow on plan or budgetary calculations? (In passing one can be sure though that repayments of I.M.F. drawings have not and will not cast a corresponding shadow!).

25. I take the case of a *compulsory deposit*. At best, it can be justified at a time of exceptionally severe inflationary pressures and that too for a short period of time. But the attraction for it continues — and has to continue for the same arithmetical reasons even though the plusses and minusses become nearly equal as time goes on even on strictly arithmetical terms so that what we have is more a shadow than a reality. Similarly, new borrowing instruments are introduced and their yield taken credit for without any explicit recognition of the impact on the yield from existing instruments. When it comes to taxes, we do not have to enlarge on how indirect taxes and even direct taxes are passed on or evaded or both — giving a further twist to inflation rather than controlling it. And in an arithmetical approach to budget-making, the impact of taxation on the incentives to work, save and take risks tends to be generally overlooked.

26. I hope I do not sound nihilistic. It is not my intention to suggest that there is no scope for any change in fiscal policy. Far from it. But it is a fact that focussing so exclusively on magnitudes like the budgetary deficit in a year to year context has created an illusion of policy even though the policy measures make little lasting impact and may even have an adverse impact on balance. If we had traced the full effects of policy measures over time and had allowed for consequential action by other partners in society — i.e., for our favourite concept of a struggle for retaining or enlarging one's share — we certainly would have chosen a different policy-mix and devoted more attention to structural or long-term changes, i.e. both to long-term changes that might be under way and those that need to be initiated. Again, I do not wish to exaggerate. Surely the indirect and long-term effects have not been totally overlooked in the pursuit of simplistic arithmetical or aggregative targets. But some such tendency there certainly has been; and I do believe that acceptance of the suggestions we have made, in particular, a correct delineation of budgetary deficits, an explicit statement of monetary targets with appropriate break-down of credit to Government, private sector and external sector, and a fuller tracing of the origins of inflationary pressures as also of the direct as well as indirect and long-

term consequences of proposed anti-inflationary measures would lead to a better policy-mix and a greater success in controlling inflation than in the recent past.

27. Once it is recognised that even standard excess demand situations have elements of struggles characteristic of cost-push impulses, that policies have to be sufficiently disaggregated and that the direct as well as indirect and long-term consequences of policies have to be borne in mind, it becomes clear that *anti-inflationary policies cannot be fully successful* and it may not even be desirable to push too far in the direction of inflation control. Economic policies alone do not wear down the appetite for struggle; and incomes-policies, while necessary, are in the nature of things compromises — of the one step forward and half-a-step backward sort. As for disaggregation, surely we have to go beyond the usual three-sector model of the economy and address ourselves to questions like reduce wasteful expenditure and unproductive or less productive investment but not useful production or investment; reduce consumption, but not of the weakest; weed out the inefficient but not too fast and so on. The instruments available, whether of monetary, fiscal or export-import and exchange-rate policies are not sufficiently versatile, in the sense that either they can be evaded or are not capable of being wielded effectively for institutional reasons or because the causal connection between them and desirable objectives are not operative all in the same direction or because the relevant elasticities of supply and demand are not significant enough.

28. Controversies abound in respect of each instrument, be it interest rates, exchange rates, taxes or direct controls; and it is beyond the scope of this talk to evaluate these controversies. Suffice it to say that the proof of the pudding is in the eating thereof. Even after producing unemployment of more than 30 million persons, the Western Society has not been able to get rid of inflation. The average rate of inflation in OECD countries now is of the order of 5 per cent; and with even a modest recovery, the chances are that this rate will accelerate. The very fact that *floating rates* are now considered unavoidable, even though a bit of a nuisance, is an *admission that inflation is not fully controllable* — or at least not to the same extent at any given time in different countries.

29. Those of us who are accustomed to thinking of *economics* as a *science of choice* — of reconciling different objectives that have to be achieved with limited means and with equally limited policy instruments — should not really be surprised by the conclusion just reached. One does not have to be a Pundit to realise that it is better to give up the first half when confronted by the danger of total loss if by so doing we can be sure of retaining the other half. But in real life, choices are not so simple or obvious. At each point, there is a spectrum of uncertain loss and uncertain gain; and the loss and the gain can be influenced by

appropriate policies. But the effectiveness of different policy instruments varies in direction in relation to different objectives and is in any case subject to a wide margin of error or variation as to magnitude. In steering a path through such a complex maze, the Pundits can often go wrong and the simpletons can sometimes succeed. What is certain is only the inevitability of choice and the difficulty of verifying its wisdom in retrospect as it is seldom possible to retrace one's steps. *Inter-temporal or inter-country comparisons and correlations or abstract theoretical models* can help in avoiding gross errors. They cannot provide parameters for fine tuning of policies; much less can they establish immutable laws. Much of policy-making in real life has to be improvised as we go along even if such improvisations are with reference to some rough and ready principles of action.

30. It is of course possible that if nations persist with anti-inflationary policies even if they imply on an average very high rates of unemployment of 7 or 8 per cent of the labour force, the expectations about inflation would change downwards. This would also be the case if there is an erosion of all those institutional factors which prevent prices from going down even when productivity rises or supply conditions are propitious. One of the most powerful factors that can impart greater downward mobility to prices is competition; and unless protectionist forces gain sway, the rise of more and more newly industrialising countries will add to the force of competition everywhere. Some of the newer technologies such as electronics or computer technology may also revive the forces of competition. A combination of all these factors may lower the social, political and economic threshold below which inflation cannot be reasonably rolled back. But the fact that there would be some barrier over the foreseeable future cannot be seriously disputed.

31. It may be argued that the experience of industrially advanced countries is not very relevant to India as their inflation is to a greater extent of the cost-push variety and that a *cost-push impulse is more difficult to control*—say, by monetary policy. Even monetarists, I think, are speaking tongue-in-cheek or at least figuratively and indeed euphemistically when they assert that cost-push price rises will not take place or be cumulative if monetary policy was "not accommodating". The velocity of money does change and often to make up for the lack of monetary oxygen; and there is sufficient substitutability as between different financial instruments and variability as to their liquidity quality. Given these facts, if monetary policy is required to nip cost-push impulses in the bud, it will have to be not just "non-accommodating"; it will have to be pretty savage indeed.

32. While it is certainly true that cost-push impulses are not as easy to control as situations of excess demand

by monetary policy (or for that matter by fiscal or exchange rate policy), I do not think the contrast between India and the industrially advanced countries in this respect is all that great. For one thing, we have already argued that the difference between excess demand and cost-push is of degree and not of kind. Again, in so far as cost or supply factors are market determined, there is no reason why the situation in India should be different from that anywhere else. Energy prices affected us even more than they did most other countries. Agriculture is more subject to fluctuations than industry; and even the oft-asserted comparative decility of Indian labour which makes them followers rather than leaders in a wage-price chase is perhaps becoming less valid with the passage of time.

33. In any event, we have our own peculiar problem of recurrent shortages of basic commodities, particularly of food which tend to push up prices from time to time. No one would argue that monetary or fiscal policy can take care of this problem. Nor can price control or rationing or even the much talked of public distribution system which may be necessary even when food supplies are generally adequate but is never sufficient when they are not. The only solution when it comes to controlling inflationary pressures which arise from periodic shortages of basic commodities is to eliminate these shortages — either by producing more on an average, or by importing more while the former is being attempted. It is no use saying we cannot afford such imports — because afford we must in the short-run; and if we cannot afford them in the long-run, we should alter all our long-term plans and policies so as to produce more of basic goods at home. I do not believe that important as export promotion is, it can be an answer in our circumstances to the problem of obtaining adequate supplies of essential mass consumption goods.

34. Some of you are perhaps reminded at this stage of the controversies that surrounded the formulation of our second five year plan. Advocates of physical planning were right in insisting that the mere availability of finance will not ensure that the right inputs will be forthcoming at the right time or that the composition of the final output will be such as to sustain a faster tempo of growth in future. But equally, the advocates of financial planning were right in reminding us that goods produced will not be demanded or move where they are wanted unless income flows are suitably modified by financial planning. And then we had Prof. Vakil and Prof. Brahmaiah to remind us rightly that, in the short-run at least, there are limits beyond which income or financial flows cannot be manipulated so that when it comes to basic consumer goods, we have no choice but to produce them. I hope it is not uncharitable to conclude that we were all then like the proverbial blind men describing an elephant. But we all had a piece of the elephant all right.

35. In this sense, there is some truth in the assertion often made, particularly by businessmen, that inflation ought to be controlled not just by control of demand but by stimulating supplies. Indeed in the long run, the latter is the only acceptable solution; and even in the short-run, when it comes to basics - i.e., Roti, if not Kapada and Makan - adequate supply is the only practicable solution. But at the same time, it has to be emphasised that short-term supplies are not perfectly elastic so that some restraint of demand (at least of non-basics - and here lies the rub) becomes necessary. Even in the long-run, if supplies rise at increasing cost per unit of output, prices will rise. This is only another way of saying that *rising productivity is of the greatest of importance if inflation is to be controlled to a greater extent over the long pull.* Rising productivity makes it easier to accommodate the struggle for greater shares - for ultimately, the struggle is most often for more for oneself rather than for more at the expense of others as long as this can be avoided.

36. The proposition that inflation control becomes easier when productivity is rising fast can also, I think, be turned around as it is equally true to say that, other things being equal, *it is easier to tolerate a higher degree of inflation if productivity is rising faster.* The distortions created by price rise are of two kinds: those that create tension, unrest and ultimately lower productivity because of distributional changes associated with price rises and those that distort patterns of investment and reduce savings. As long as the latter set of distortions are avoided by keeping real rates of interest positive (but not so high as to discourage risk capital), the rise in productivity will help in minimising distributional conflicts and in correcting them as they arise. It is in this sense that *rising productivity is at the heart of economic success* - it makes for a higher rate of saving and investment, and, therefore, for greater ease of adjustment in response to unavoidable changes as also greater margin of tolerance in pursuing expansionist policies, all moving in a virtuous circle.

V

CURE AND ENDURE INFLATION

37. What is a tolerable and unavoidable rate of inflation must, therefore, remain a matter of pragmatic judgement rather than of universal or dogmatic assertion. My judgement would be that in India, with our low degree of productivity increase (which is really a shame as it stems, I am convinced, largely from the attitude to work on the part of all classes of our people), the social and political margin of tolerance for inflation would be on the low side. Till such time as we succeed better in raising labour productivity all round we would be wiser to sit up and take urgent remedial action as soon as price rises threaten to exceed,

say 4 or 5 per cent per annum on an average — or even a little less. In any event, I would urge that we follow as a matter of routine for all time all the other recommendations made earlier, including the policy for the import and production of essential consumer goods, a positive but not high rate of real interest and open and explicit and sufficiently disaggregated approach to fiscal credit and foreign exchange targets or variables while recognising the limitations of any purely arithmetical approach and realising the importance of resolving promptly and directly all conflicts as they arise. For some time to come, stability of policies in regard to taxation with necessary fiscal adjustments made primarily through control of expenditure would also be most beneficial. Above all, we would do well to focus more often on the mainsprings of economic momentum, viz., productivity and savings,— at least as often as we focus on prices and money supply which are at best only partial indices of success or failure in economic management.

38. And last, but not the least, if all this does not suffice to eliminate inflation, measures must be found to make inflation tolerable or endurable. This means essentially two things. *The real rate of interest should be*, as already mentioned, *positive but not high so as to avoid production of savings and distortion of investment.* A high real rate of interest also distorts in the sense that it unduly favours loan capital over equity capital. Secondly, in so far as a very high rate of productivity increase does not ease distributional problems, *there should be indexation particularly of wages and salaries.* This does not mean any automatic and universal formula of indexation which is applied frequently — say once every month — to all forms of payments. Some staggering and reasonable periodicity in wage-revisions would be essential. But the present practice of virtually excluding incomes above rather moderate limits or pensions from indexation even with some staggering cannot be justified if even a moderate degree of inflation of 3 or 4 per cent per annum is here to stay.

39. As far as *interest rates and tax provisions* are concerned, they could be revised periodically and so can *administered prices* for a few key commodities. But the procedure for revision should be taken out of the political arena so that these important decisions are not politicised and neither too much nor too little and too late a revision is made. For indirect taxes, the best way of immunity from political pressures would be to put them all on an *ad valorem* basis. On the whole, while I can see the need for administering some prices such as that of money or foreign exchange or wheat or even coal and steel, there is little justification for widespread price controls or even for dual pricing when it comes to commodities like cement.

40. The important principle is that if some inflation is here to stay, one should not be too heroic in fighting it by resisting even those price or income changes which

neutralise price changes that have already taken place elsewhere. I realise that this raises the knotty question of who is chasing whom and of whether price rises may not become cumulative and their pace accelerate — let alone when and which price changes are desirable or inevitable and which are not. That is the kind of *difficult question incomes policy has to handle*. But the difficulty of handling it does not mean that we should leave everything alone or that we should resist all changes as long as we can. That way lies surely financial and industrial chaos and worse. *How to devise an effective incomes policy without directly controlling prices and wages is perhaps the greatest challenge of our times*. Greater use of *ex-post profit-based bonuses* rather than rigid *ex-ante* escalation or indexation, *compulsory and quick arbitration* in the event of industrial disputes and a flexible use of *imports and even subsidies* on a modest scale could all be essential parts of a sensible way of living with inflation, at least when it is of modest proportions. From time to time — when price rises tend to exceed the limits mentioned — we may have to tighten the fiscal and monetary screws as well as liberalise imports, taking care to build up reserves of food, fibre and foreign exchange when times are more propitious.

41. Let me also mention just in passing that even with a low rate of inflation, there must be quick and *corresponding adjustments in the exchange rate*. While our present system of linking the rupee with a basket of currencies provides a satisfactory way for adjusting to relative changes in the exchange rates between major currencies, we should not forget that by itself, i.e. without changing deliberately the nature of the link, we cannot correct any distortion that might arise if our inflation rate gets out of line with that of our major competitors.

42. The question has often been asked why we cannot forget about controlling inflation or keeping price rises to any sort of minimum. Why can we not, *a la Brazil, index everything and let inflation take its course* as after all this will take care of the distributional as well as the investment distorting and savings reducing effects. All that would be left of the bad effects of inflation would be the so-called menu-effect — that is the cost of changing price-tags too often or the shoe-leather cost of going to the bank frequently to get money. I have instinctive resistance to such a proposal for universal and prompt indexation although I cannot articulate fully my reasons or rationale for it. But it has something to do with the feeling that the human mind boggles before too rapid a change and refuses to believe that the pace can be kept up. Faced with a very rapid pace of change, therefore, it begins to behave cautiously and perhaps irrationally, but nevertheless in a manner which becomes cumulatively enervating. It has certainly something to do with the belief that *no scheme of indexation can completely indemnify everybody against all price rises* — if only because systems of communication are never perfect

over long distances and among people with differing degrees of intellectual sophistication. The idyllic picture of everyone ballooning skywards at great speed and in complete harmony is seldom correct — and even a degree of error or lack of ability to keep in step with others would be fatal when they are moving so fast. That demon of expectations is also so unpredictable. Nor does the success of Brazil appear so dazzling in the light of recent experience; and its success in any case may be due more to other factors making for a high rise in productivity than the seemingly infinite freedom from worry about inflation. I realise all this is not very firm ground. But such as it is, that is where I have arrived for now in regard to this vexed question of universal and prompt indexation.

VI

CONCLUDING REMARKS

43. Ladies and Gentlemen, I should now attempt to summarise this long and subjective survey. I hope my message is clear enough. If I may revert to the title of my talk, inflation has to be fought resolutely and on all fronts with an intelligent use of all the instruments available. Even so, it will have to be endured to some extent. But the more resolutely it is fought and the more successful we are in raising productivity and savings and in maintaining social harmony, the easier it will be to endure it. In the ultimate analysis, inflation is as much a social and political phenomenon as an economic one; and it should not be approached in simplistic terms or sought to be controlled by seemingly simple recipes such as controlling the quantity of money. It is useful, nevertheless, particularly in our circumstances, to operate with a fairly disaggregated monetary budget. But the formulation of such a budget can only be the beginning and not the end of policy. In particular, one should not succumb to a purely arithmetical approach to monetary or fiscal budgeting. One cannot also overlook the overriding importance of adequate supplies of basic consumer goods or of some mechanism for holding the scales even between different groups, by whatever name we call such a mechanism. The struggle against inflation is a continuing one, and the measures designed to combat it should be equally capable of sustained effectiveness. As in the case of original sin, success is by no means guaranteed or likely to be complete and everlasting; but let us not forget that there are no similar limits below which failure cannot drag us. There cannot, therefore, be any question of complacency towards inflation even if one may warn against too heroic a posture of eradicating it from our midst.

44. Once again, Mr. Chairman, I am grateful to Professor Rath and to the organizers of this lecture series for giving me an opportunity to reflect on this important subject as a token of my tribute to the memory of the founder and the builders of this remarkable Institute which continues to add lustre to its illustrious name and heritage. I thank you.

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