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INTRODUCTION

It is a great privilege and an honour for me to be invited to deliver the third Shri R. Venkataraman Endowment Lecture. I thank Dr. D. K. Srivastava, Director and Professor U. Sankar of the Madras School of Economics (MSE) for the invitation. I have fond memories of the founder of MSE, the inimitable Raja Chelliah. He left a legacy to the nation of two outstanding institutions, the National Institute of Public Finance and Policy at New Delhi in the North and the MSE at the dynamic capital, Chennai, of the fast growing state of Tamil Nadu in the South. Chelliah aptly captured a well known description, probably from Vishnu Purana, among many of boundaries of Bharata Varsha as "Aasetu Himavat Paryantam" from South to North or "Himavat Setu Paryantam" from North to South in his institution building.

President Venkataraman (hereafter RV as he was widely known) was an economist and a lawyer. He served the nation with great distinction in many capacities, as a Member of Parliament and Tamil Nadu State legislature, as a trade union leader, Minister of Industries and Labour in Tamil Nadu and Union Minister of Finance in the Indira Gandhi Cabinet after the 1980 election. His achievements were many and well known. In his second lecture of this series in March this year, Vijay Kelkar spoke of his critical role as President during the turbulent times of 1987-1992 when the nation experienced political instability with three Prime Ministers during December 1989 and June 1991, a severe macro-economic and balance of payments crisis in 1991 that brought the nation near default on its external debt, downgrading of its credit rating, and above all the humiliation of having to pledge the nation's gold stock abroad for short term credit. The period also saw the initiation of hesitant and piecemeal economic reform and liberalization in the mid 1980s and systemic and broad ranging reforms in 1991. In many ways, RV's last two years as President saw a transition of the Indian economy from a stagnant insular inward oriented one to a dynamic globally integrated one in trade in goods services as well as finance. Let me join in Kelkar in saluting RV for having played a crucial role of support during this critical period as well as his manifold achievements.

My topic today is the recent bouts of inflation. India now has the dubious distinction of having by for the highest rate of inflation of 7.5 percent among the world's largest economies in 2010. Naturally I turned to RV's thoughts in speeches presenting the budgets of 1980-81 and 1981-82 as Finance Minister, since he then faced the spectre of rising inflation and international economic environments similar, though not identical, to what we face today. Of course then, the monetary policy of the Reserve Bank of India

(RBI) was totally subservient to the dictates of the Ministry of Finance and the non-public sector commercial banks were far less relevant for credit disbursement and selective credit controls were ubiquitous. Above all the shift away from the capital-intensive heavy-industry oriented industrialization and import substitution as the development strategy and restricting domestic and import competition, all implemented by the infamous Licence-Permit-Raj was yet to happen. One of the ostensible justifications for the nationalization of commercial of banks in 1969 was a form of the current mantra of "financial inclusion". Allowing for these differences, RV's clear understanding of the policy tasks, both monetary and fiscal is not only remarkable but also continued to be relevant now.

In his speech on the 1980-81 (final) budget, RV noted the serious deficiencies in the performance of the infrastructural sectors of coal, railways and particularly in power with planned and unplanned outages and a low capacity utilization of 45 percent of thermal capacity. These along with a drought in 1979-80 led to significant drop in aggregate supply and an inflation of 20 percent. He went on to say, "In the light of the problems currently facing the economy the tasks to be accomplished are clear enough. As there is a great deal of inflationary potential in the economy, the prime objective of our policy will be to achieve price stability. This will have to be done through an increase in aggregate supply and a moderation of aggregate demand. Therefore, we intend to continue our efforts to improve the working of the infrastructure and to augment available facilities with investment wherever necessary … With regard to demand management, we shall have to pursue a policy of linking bank credit expansion to productive and priority purposes and checks the diversion of funds to speculative ends. We will also have to pursue an interest rate policy which will help in the abatement of inflationary pressures without hurting productive activity … Since there is a great deal of liquidity in the system, there is an obvious need to minimize the growth of money supply by keeping the budget deficit at a much lower level than in 1979-80. This will require a fiscal policy which will reduce wasteful and unnecessary expenditure, invest resources in increasing the economy's production potential and maximize the revenue potential of the existing tax system"(Government of India, 1980). Three decades after RV's speech it is sad that the issues of poor infrastructure performance, high fiscal deficits and incipient inflationary pressures are still with us. I will argue later on that his implicit recognition of the need for coordination of fiscal and monetary policy tasks no longer seem to exist. On the contrary the two seem to be pulling in opposite directions.

In presenting the next year's budget in 1981-82 RV noted the improvement in the inflationary situation and understandably took credit for it. But he was by no means complacent. He said "I must caution however that although inflation has abated, it has not been overcome. The economy remains subject to continuing cost push pressures, including especially the transmission of international inflation through rising prices of oil and other essential imports … It is essential to evolve a strategy for coping with cost-push inflation effectively by tackling – the problem at its roots. This is not only a matter of demand management. It also requires an all out effort to increase efficiency and achieve higher productivity" (Government of India, 1981). With the easing of the crisis situation of the previous year he argued, "The emphasis in 1981-82 must therefore shift from crisis management to growth … But it must do so in the full knowledge that the threat of inflation has not been fully overcome. The fiscal deficit should therefore be kept within tolerable limits (*ibid*) I will come back later on to the growth slow down since the last quarter of 2009-10. It possibly reflects increases in repo rates by RBI alone with no apparent action by fiscal authorities.

Interestingly he highlighted a problem that also persists even now but that is not often discussed, namely, the stagnation of the share of financial savings of the largest saver accounting for 70 percent of domestic savings of the economy, namely, the household sector, at around 11 percent of GDP or about a third of the total gross domestic savings rate of around 34 percent of GDP in 2010. He put it in slightly different terms, "Along with fiscal discipline we must also take steps to encourage the flow of private savings into the financial system … This flow of resources into the financial system is threatened in two ways and we must tackle both. First of all, it is threatened by the pernicious growth of the black economy. A second impediment to financial savings is the existence of high rates of inflation". Again black money stashed away in secret accounts abroad and inflation is with us now.

I will note later on that our current Finance Minister Pranab Mukherjee in his recent *suo motu* statement in the Parliament on November 27, 2011 on inflation and a durable solution for it, in essence, re-emphasized RV's diagnoses of the malady of inflation as well as preventive and curative cures for it.

We all owe a deep debt of gratitude for the clarity and foresightedness of RV's vision for our diverse economy, its plural society, and its democratic polity and for his quiet but firm guidance during a very turbulent period.

MEASUREMENT OF INFLATION[1]

Containing Inflation, defined somewhat loosely as a sustained increase in overall prices over an extended period of time is a concern of policy makers including central banks of most countries of the world including India. In this lecture, I will explore several aspects of inflation in India, particularly the analytics of the inflation process; trends in price changes since 2004-05 till November 2011. Monetary policy tools are the primary, though not the only, policy instruments for dealing with inflation. Central Banks are charged in many countries with maintaining price stability as one of the macroeconomic objectives of monetary policy in combination with other objectives, such as sustaining full employment or ensuring that the aggregate economy operates at or close to its potential. Implicit in these objectives is to contain the adverse consequences of sustained inflation, unemployment, and unutilized potential of the economy on consumer welfare. RBI's ultimate objective is sustained growth with financial stability. It must be recognised that from Dadabhai Naoroji in 1899, and the report of the National Planning Committee of 1938 chaired by Jawaharlal Nehru, the Bombay Plan of businessmen in 1943 and the Peoples Plan of Indian federation of labour in 1944, eradication of poverty measured by the population living below the poverty lines defined by each, has been the single overarching and intrinsic objective of the nation with rapid and well distributed growth as the primary instrument for achieving it. The mantra of "inclusive growth" chanted *ad nauseum* by national and international agencies was better understood by these visionaries.

In almost all countries of the world, the consumer price index (CPI) is used for measuring inflation. On the other hand, broadly speaking, prices received by producers at the farm or factory gate influence their incentives for production and hiring. As such, a Producer Price Index (PPI) is also used in policy discussion in many countries in conjunction with an aggregate CPI.

Neither an aggregate CPI (until very recently) nor a PPI are compiled and published in India. Inflation is measured in India by the rate of increase in any period (week, month or year) over its value in the corresponding period of the year before of the Wholesale Price Index (WPI). This year-on-year or y-o-y rate of increase is called

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[1] I have drawn extensively on my unpublished paper, Srinivasan (2011a), in this lecture.

Headline Inflation. In addition, policy makers and particularly the media document the trend in one particular component of WPI, namely, the index of Wholesale Prices of Food Articles. To call it, "Food Inflation" is misleading since doing so does not distinguish between a rise in price of food articles at the same rate as the rise in overall prices and at a rate different from it. The former implies no change in the prices of food articles relative to the basket of all commodities.

The inappropriateness of using WPI for measuring inflation has long been recognized by policy makers including former RBI Governor Y. Venugopal Reddy and the current Governor Subbarao. Yet according to the latter, the RBI has opted for WPI over Consumer Price Index (CPI) for a number of reasons, one of which being that until February 2010 an All India CPI for consumers was not available. Another reason of WPI's alleged clarity in communicating RBI's policy stance. Neither reason is particularly convincing. Moreover the Indian WPI, is neither a producer, nor even strictly speaking, a Wholesale Price Index, since it uses retail price quotations for some and wholesale prices for other commodities. It does not include services. Unlike the almost universal practice of publishing seasonally adjusted prices indices, no such series of WPI or CPIs are published in India. Although each of the four available CPIs covers a different subgroup of the population, they all include services. It is also the case that trends in the four CPIs in WPI often differ. Still, there is no reason for not using them altogether. After all with the economic knowledge and statistical power in RBI and in Ministry of Finance, some sensible statistical adjustments could have been made to take into account their deficiencies and so adjusted aggregate CPI could have been used. In any case, it is to be hoped that once enough data with the new CPI accumulate, the RBI will switch to its use for monetary policy formulation.

I have discussed the deficiencies of WPI and possible reforms elsewhere (Srinivasan, 2008a and 2008b). I proposed that in addition to the new CPI, a new appropriately defined producer price index (PPI) _ as well as a cost of living index (COLI) should be compiled and published. The inflation rate, rather than a COLI currently plays a role in determining adjustments in dearness allowance of employees of the organized sector including the Government and Government aided institutions. Further in India there are no systematic procedures for incorporation of new goods and quality improvements in old goods in the price indices. Although such procedures exist in US, they have been found by the Boskin Commission to be inadequate and may have resulted in the overstatement of CPI inflation. Introduction of systematic procedures for reflecting quality improvements and the availability of new goods in price indices in India is urgent, given the strong theoretical presumption and empirical evidence that with trade liberalization and greater competition, the pace and quality of improvements and widening range of goods available in the market has been accelerating. Since these changes took place over a period of time and their full impact may take even more time to be realized there is a strong presumption that the Inflation rates in India are overstating their true values although the extent of overstatement cannot be ascertained without a careful empirical study.

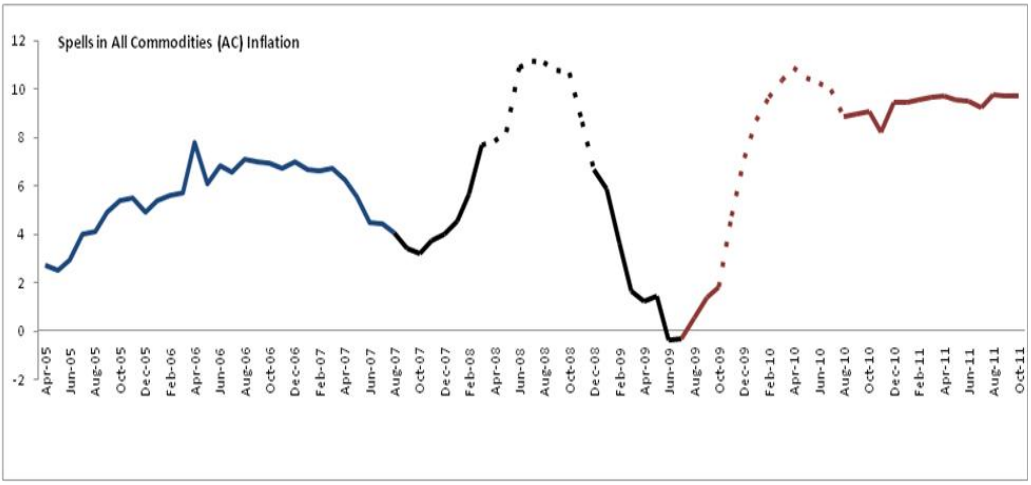
TRENDS IN INFLATION: HEADLINE INFLATION

The trends in the monthly Year on Year rates of change in WPI for all commodities from April 2005 to November 2011 and weekly price trends for some important items till December 17, 2011 are available. Obviously one could define other rates in a similar fashion---for example, the annualized percentage rate of change of the current week's index over its value in the previous week is a very short-term week on previous weak inflation rate. It is easy to see that these rates, being all based on the same data necessarily imply purely arithmetical inter-relations among each other. Also except for inflation measured cumulatively from the base year, others are affected by the so called "base effect".

The weekly inflation rates are likely to be more volatile than monthly and annual rates. The trends in monthly rates suggest that in the 80 month period from April 2005 to November 2011, the most recent spell of sustained inflation for all commodities seem to have begun in August 2009. In 24 months from December 2009, monthly rates of inflation exceeded 7 percent, and in 19 of them, 9 percent. In fact, this spell itself was preceded by another of 30 months from April 2005 to September 2007. Taking the two spells together in the 80 months between April 2005 and November 2011 inflation rates were 7 percent or higher in as many as 45 months.

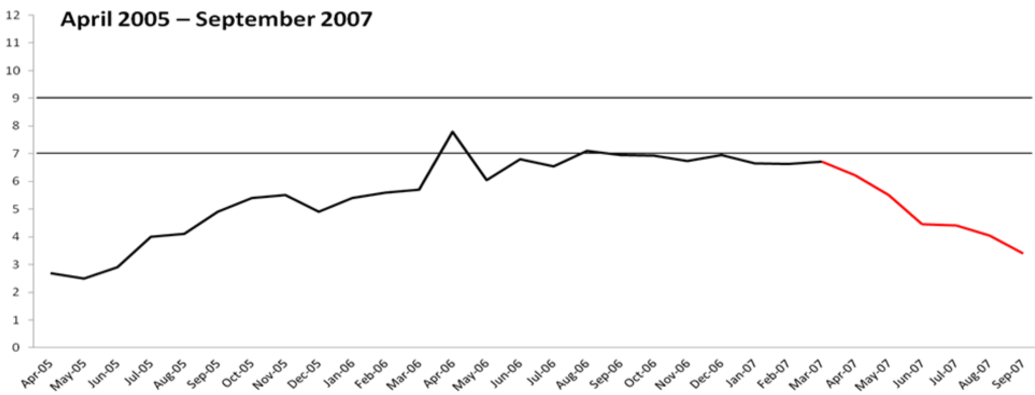
The spells until October 2011 are shown in a temporal sequence in different colours in Figure 1, and each component of this sequence of spells is charted in Figures 2A, 2B, and 2C, respectively. The rising and declining phases of each spell are also illustrated. Clearly the seeming persistence of inflation near 7 percent or higher a year over such a long period calls for an analysis in depth of its determinants that goes beyond ad hoc explanations.

Figure 1: Spells in All Commodities Inflation



Legend:
First Spell: April 2005 – September 2007
Second Spell: October 2007 – July 2009
Third Spell: August 2009 – October 2011
Basu's spell: March – December 2008; December 2009 – April 2010

Figure 2A: Spells of Inflation All Commodities (AC) Disaggregated – Spell 1



Legend:
Rising Phase:
Declining Phase:

Figure 2B: Spells of Inflation All Commodities (AC) Disaggregated – Spell 2

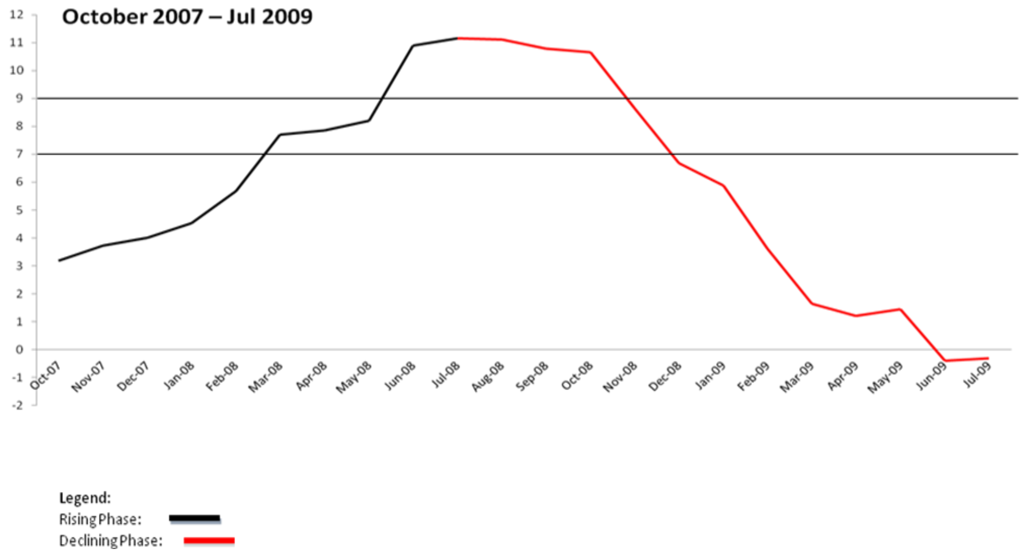
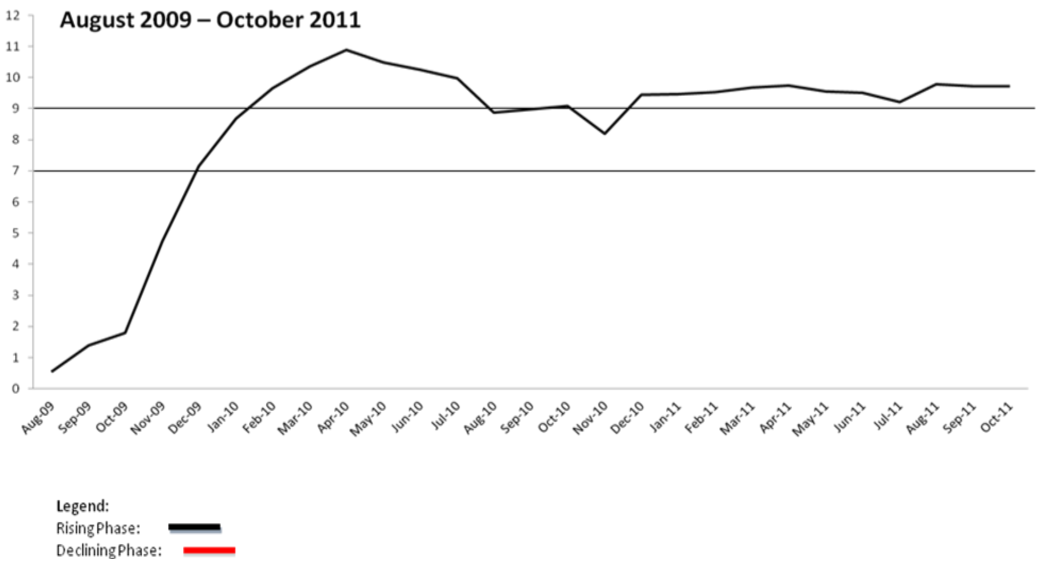


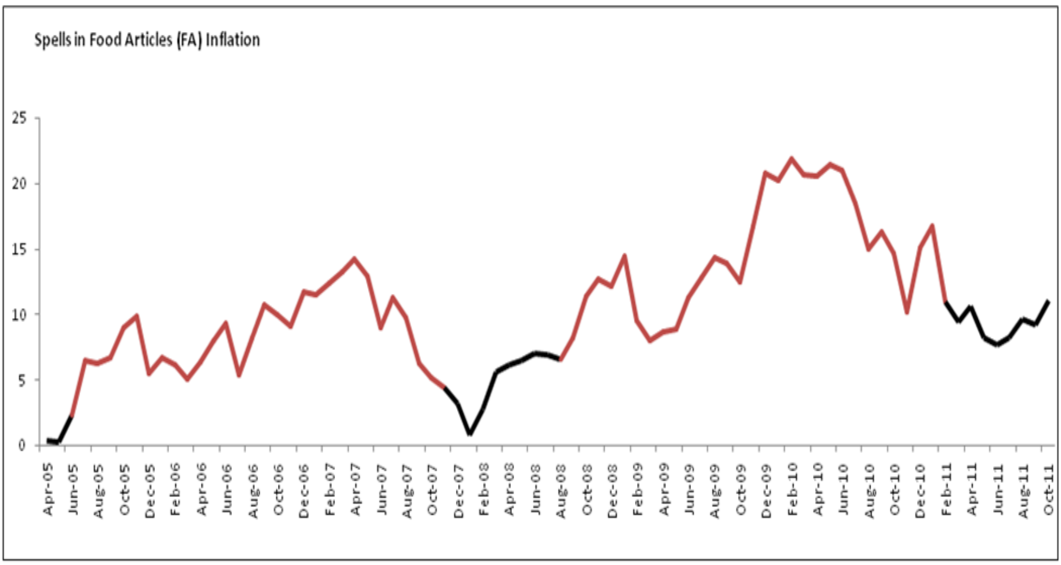
Figure 2C: Spells of Inflation All Commodities (AC) Disaggregated – Spell 3



TRENDS IN INFLATION: FOOD INFLATION

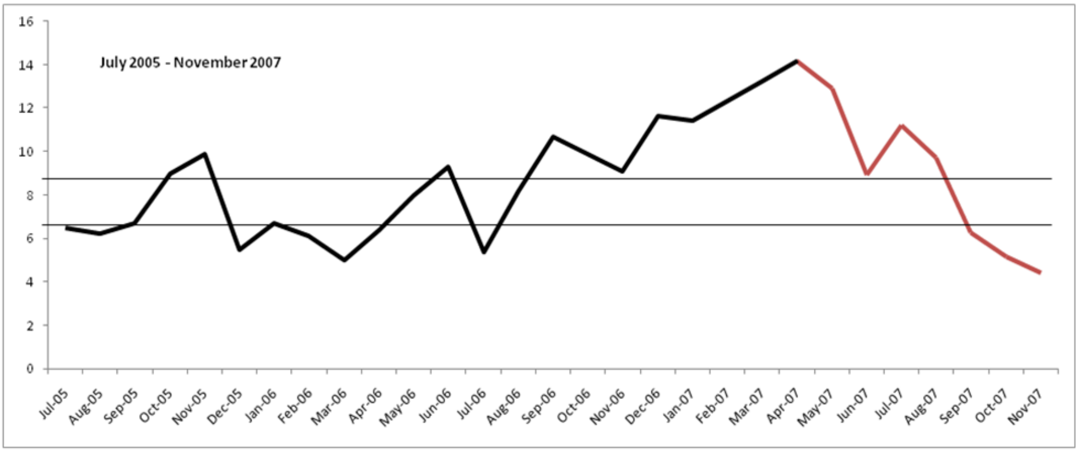
The time pattern of changes in the price of food articles is not the same as that of all commodities. In the period of 80 months since April 2005 in 55 months, nominal food prices rose faster than the nominal value of the bundle of all commodities. However, 53 of the 55 observations were in just 2 long spells, with 26 of them in the 29 month period from July 2005 to November 2007, and another 27 in the 29 month period from October 2008 to February 2011. The two spells until October 2011 in inflation of Food Articles Prices are shown in temporal sequence in Figure 3 in different colours. Each component of this sequence of spells is charted in Figures 4A and 4B respectively. The rising and declining phases of each spell are also illustrated.

Figure 3: Spells in Food Articles Inflation



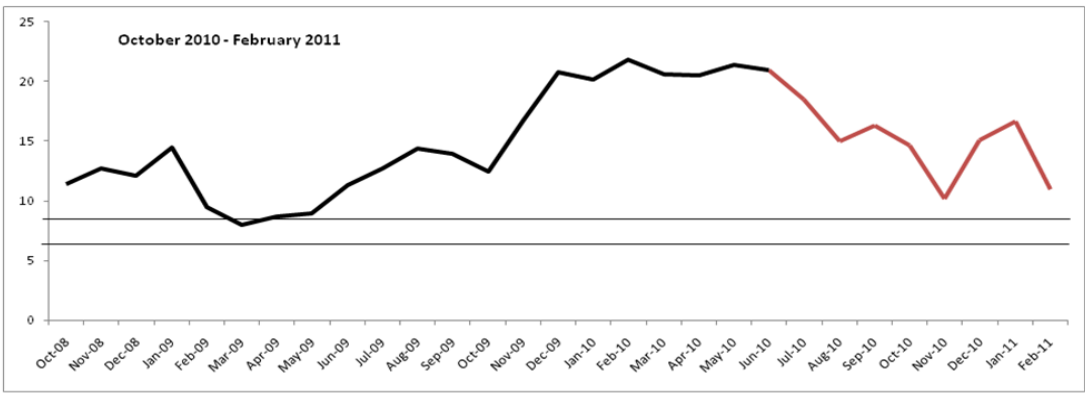
Legend:
First Spell: July 2005 – November 2007
Second Spell: October 2008 – February 2011

Figure 4A: Spells of Inflation Food Articles (FA) Disaggregated: Spell 1



Legend:
Rising Phase:
Declining Phase:

Figure 4B: Spells of Inflation Food Articles (FA) Disaggregated: Spell 2



Legend:
Rising Phase:
Declining Phase:

Clearly the relative price of food articles has been rising for most of the period of 80 months since April 2005. In 35 months, inflation in all commodities was 7 percent or higher and in 24 of them higher than 9 percent. Inflation in food articles however was at or higher than 7 percent in as many as 55 months and above 9 percent in 44 of them.

REPO RATES AND INFLATION

RBI's policy rate is currently the repo rate. The changes in it are meant to influence its interim target of the average of short term rates and eventually the ultimate target of inflation rate. Figures 5A and 5B highlight the repo rates of the RBI during the spells of inflation in all commodities and food articles, respectively. The rising (declining) phase of inflation in all three spells in all commodities, loosely speaking, correspond with increases (decreases) in the repo rate, though an association between a rise (fall) in the repo rate and a subsequent decline (rise) in inflation rate cannot be clearly seen. However a similar pattern is not seen in inflation in food articles. The rising phase of the second spell of inflation in food articles corresponds with a reduction in the repo rate.

Figure 5A: Repo Rates of RBI and Spells of Inflation in All Commodities

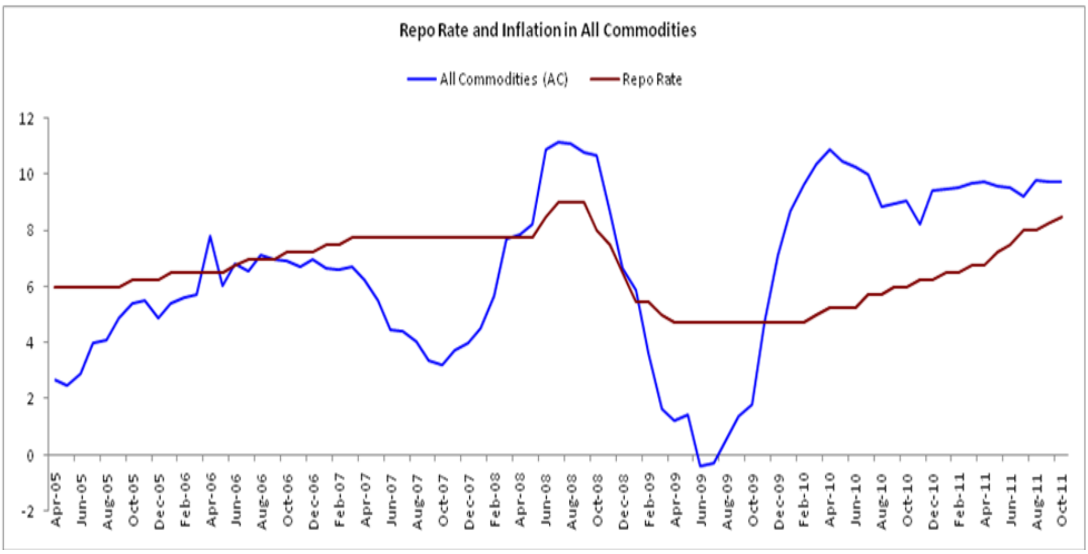
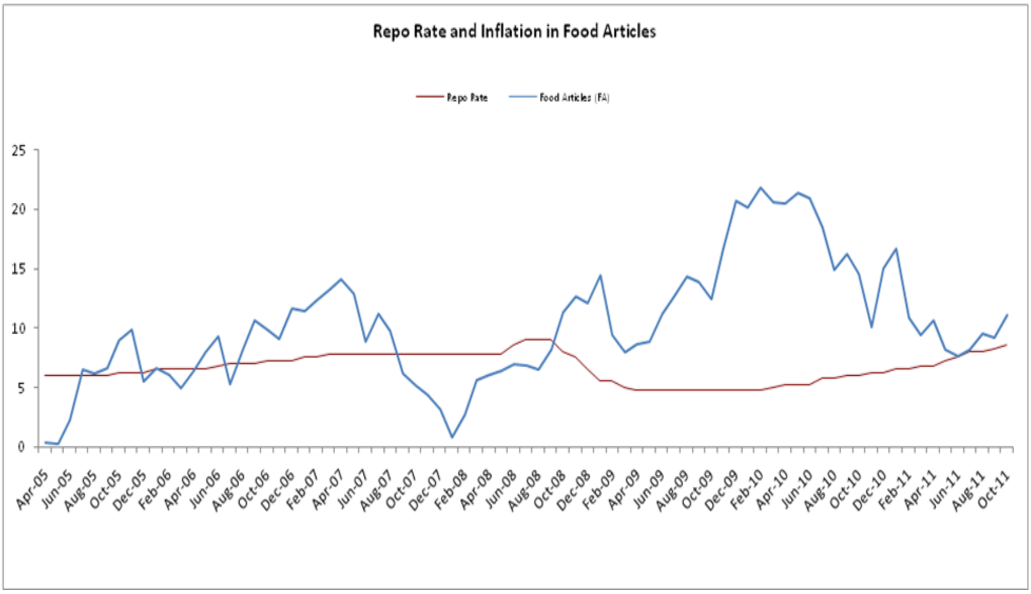


Figure 5B: Repo Rates of RBI and Spells of Inflation in Food Articles



A simple correlation between inflation in all commodities and repo rate in this graph yields a positive coefficient of 0.39, and negative coefficient of -0.47 between inflation in food articles and the repo rate. Although this is counter-intuitive, as is will understood the existence of a statistically significant (positive or negative) correlation or lack thereof has no necessary implication for the existence of a causal relation and its direction between the two. But the analytics of inflation and the relation between inflation in food articles and all commodities are important issues.

THE ANALYTICS OF INFLATION

Without understanding the analytics of inflation formulation of effective policies for tackling it would be impossible. First, Inflation being about changes in nominal prices over time is a dynamic stochastic process requiring an inter-temporal framework incorporating the stochastic shocks to the economy for its analysis. Second, whether Milton Friedman's famous statement that "Inflation is always and everywhere a monetary phenomenon, in the sense that it can be produced only by a more rapid increase in the quantity of money than output" is a tautology or a deeper causal explanation, any analysis of inflation necessarily has to include consideration of monetary policy and financial sector behavior. Third, since the public policy as well as private concerns about inflation largely arise from its effects on the real sector, for analyzing them an integrated framework of the real and monetary sectors is essential. The real consequences are on consumer welfare, aggregate and sectoral outputs and growth, real investment, employment and so on. Clearly in a largely competitive market based private sector economy such as ours, decisions about what to produce, to consume, to export, import, investment in real and financial assets and their economy wide or aggregate consequences depend on the prices faced by those making the decisions at a point in time and overtime. Since some investment and in part production decisions will have their impact only in the future in the near and longer term, and the future prices are unknown and uncertain at the time current decisions are made, as Keynes argued long ago expectations of decision makers about future prices matter. Thus how expectations are formed is a crucial issue. Anchoring price expectations is an important policy objective. Fixing the exchange rate of the currency with that of a country known to have stable domestic prices is an anchoring policy that some countries adopt. India is not one of them. Thus in India success in anchoring depends crucially on whether policy makers have built a reputation for success in stabilizing prices. But then success itself depends on the public having well anchored expectations. Further private decisions are also influenced by public policies both macroeconomic and microeconomic and any anticipated changes in them. In particular, distortions created by Government interventions in markets could also distort private decisions depending on whether interventions are meant to correct market failure or otherwise.

Any satisfactory framework to be integrated framework has to incorporate real and financial sectors and variables in a behaviorally sound way. Ad hoc frameworks of integration are likely to be unsatisfactory in one or more ways.

The recent global financial crisis of 2008 and the fact of its spread from the bursting of a real asset price (i.e. house price) bubble in the United States (U.S.) to the entire financial sector in the U.S. and then to the rest of the world was not foreseen by most analysts including academic economists. It also brought into sharp focus the inadequacies of macroeconomic and financial models. This has spawned a still growing literature on what is wrong with macroeconomics and macroeconomists.

ANALYTICAL DISCUSSIONS OF INDIAN INFLATION

A recent seminar on September 21, 2011 on inflation was organized by the National Institute of Public Finance and Policy (NIPFP) in New Delhi. The staff of Planning Commission, Department of Economic affairs (DEA), Reserve Bank of India (RBI) and academic experts of the International Monitory fund (IMF), World Bank, Asian Development Bank and others participated. Apparently at the seminar Kaushik Basu, Chief Economic Adviser in the Department of Economic Affairs (DEA) in his remarks agreed with the comment of Govinda Rao, Director of NIPFP and a member of the Prime Minister's Economic Advisory Council in his introduction that "the country's economic managers have not been able to fully grasp the processes underlying the persistence of high inflation." Such a conclusion by a senior policy maker and a policy adviser is deeply disturbing.

Basu has also published in 2011 two avowedly analytical papers in the Economic and Political Weekly, one entitled "Understanding Inflation and Controlling it" (Basu, 2011a) and the other entitled "India's Foodgrain Policy, An Economic Theory Perspective" (Basu, 2011b) Although they have some useful but largely well known insights, unfortunately both devote too much space to largely peripheral theoretical curiosa and digressions that do not contribute to a deeper understanding of the analytics of inflation, let alone on policies for addressing it.

Basu (2011a) notes that "India's highest inflation occurred in September 1974 when it reached 33.3%. Arguably our worst inflationary period was from November 1973 to December 1974 when inflation never dropped below 20% and above 30% for four consecutive months starting June 1974" (p.51). In Basu (2011b) he notes that "From October 2009 to March 2010 the year-on-year food-price inflation announced every week hovered around 20%" (p.37). It is well known that there was an episode of steep rise in food prices and inflation globally during 1973-1974, an episode that has not been repeated in the same fashion since. Basu does not ask whether and why the current episode is different from the earlier one. With regard to the divergence between the price index of food articles and the WPI since 2000, he is breathtakingly casual about the causal connection between the two. He simply asserts that in an earlier era "overall inflation was powerfully driven by the agricultural sector. Overtime, the share of agriculture in the total GDP has fallen and the growing strength of the economy (whatever he means by it), means food prices alone are no longer in the driver's seat the way they were for the first several decades after independence" (Basu, 2011a, p53).

Whether or not his assertion is valid, he should at least have examined the trends in relative price of food articles and the micro-economic factors in their determination. As noted earlier, the time pattern of the inflation rates in the two indices differed. As noted earlier in 55 of the 80 months since April 2005 the index of food articles rose faster than that of WPI and most probably earlier as well. It is hard to argue however that the falling trend over decades in the share of agriculture in GDP was the major contributory factor in the divergence between WPI for all commodities and that for food articles.

Although Basu (2011b), rightly calls for more attention to be paid to macro-demand management through fiscal and monetary policies for controlling overall inflation, his paper, including the section on interest rates and liquidity, has little or nothing to say on macroeconomic theories. His reference to Brazil having successfully lowered liquidity by counter-intuitively lowering interest rates is interesting but its relevance to the Indian context is not evident. His digression on capital controls and discussion on the possible impact on inflation of policies that benefit the poor such as the National Rural Employment Guarantee Act do not answer the basic question about the determinants of a sustained month-after-month rise in food prices during 2009-2010. Basu's paper on the Economic Theory of Foodgrain Management taken as a whole is extremely disappointing as a contribution to India's food-grain policy which is beyond the use buffer stocks for price stabilization and in particular to containing food inflation. Basu, given his well deserved reputation as an excellent economic theorist should have explained the analytics of the role of India's fiscal policy in addressing inflation.

Deepak Mohanty, Executive Director of RBI in his very recent speeches (Mohanty, 2011a, 2011b, and 2011c) addresses the role of monetary policy and RBI in addressing inflation. With inflation still unabated despite as many as 13 hikes in the policy rate (repo rate) by the RBI since March 2010 questions arise whether the transmission mechanisms between changes in repo rate and its ultimate objective of inflation rate might have changed and the lag been between a change in repo rate and its impact and on inflation rate might have lengthened. Moreover were the signals (on a weekly basis) on inflation rates and on a quarterly basis on growth rate that everybody including RBI receive used in a forward looking manner by the RBI in deciding on whether and to what extent change (in either direction) its policy rate and if yes, how were they used? Mohanty's speeches do not provide any clue on these critical questions. Mohanty mentions RBI's objective of achieving a specific threshold level inflation rate as a means for anchoring of inflationary expectations. Since RBI does not follow inflation targeting in its monetary policy, nor does it use a fixed exchange rate of the Rupee with a low inflation country as an anchor, it is unclear how it uses the findings from its own periodic survey of inflationary expectations in an analytical way. The very recent statement of the RBI that it reserves the right to intervene if necessary to address the depreciation of the Rupee seems to contradict its policy until now of letting the market forces determine the Rupee's exchange rate and intervening only to mitigate the volatility in exchange rate movements.

At a recent Confederation of Indian Industry (CII) event in Kolkata on December 9, 2011, Governor Subbarao (2011) acknowledged that the concern that RBI's hikes of repo rates 13 times since March 2010 have had no impact on inflation rates is legitimate but added " Had the RBI not acted the inflation rate now would have been 12 percent or 13 percent and not 9.7 percent at the moment" (The Hindu, December 9, 2011). This is a merely self serving assertion since he did not offer a shred of analytical evidence in its support. One could equally well argue that had the RBI acted by raising rates earlier and higher once the evidence that mini hikes were not working, probably inflation at the moment would have been much lower than 9.7 percent

Time does not permit a discussion of the paper of Mihir Rakshit (2011) that questions the macroeconomic framework of monetary and fiscal policy making in India and wants to be replaced by a structuralist one that in his view is consistent with Indian reality. He also questions the monetarist thinking behind the repo rate rises of RBI in trying to combat inflation. While analytically interesting, Rakshit unfortunately does not provide enough empirical support for his alternative framework.

This is not the occasion for delving into the more econometrically oriented papers and to my own admittedly simple and even simplistic, econometric exercises. My summary assessment is that they are neither conclusive nor informative and have no distinct take-away message. For example, on the crucial question of whether food inflation is the driving force behind overall inflation, some studies find no convincing empirical evidence in favour while others do. The fundamental problem with the studies is that they are based on ad hoc specifications without any link to economic theory.

However the thesis of food inflation as the driving force of general inflation will soon be put to test. The weekly inflation rate in food articles has been declining recently from 12.21 percent in the week ended October 22, 2011 to 0.42 percent in the week ended in December 17, 2011. In part, this is to be expected. With a good Khariff Crop following a good monsoon and the beginning of market arrival of the Khariff harvest (primary) rice, price of rice declined. Wheat prices have been declining even longer perhaps following Russia's lifting of the ban on wheat exports. It is too soon to tell whether the recent decline of food inflation is temporary or will be sustained. If it is, it will be interesting to see whether inflation rate in all commodities which was at 9.11 percent in November 2011 will begin to decline at the end of this fiscal year as the Government has been forecasting.

I will conclude by summarizing and drawing policy implications from my analysis. Let me begin with two recent developments that have implications for economic policy in general and for addressing inflation. The first is the already mentioned good news about recent decline in food inflation. Second is the bad news about the decline in real GDP growth in the second quarter of this fiscal year to an annual rate of 6.9 percent in the first quarter's 7.7 percent. Basu has attributed this in part, perhaps euphemistically to "delays in decision making" rather than appropriately to policy paralysis. Montek Ahluwalia pointed out to an investment slowdown as the cause, but the data do not bear him out. But both did not refer to the most disturbing aspect namely that the decline started from 9.4 percent growth in the fourth quarter of 2009-10 and continued in every quarter since then. Even the 9.4 percent growth itself is more a reflection of the recovery from the effects of the global financial crisis. In fact the slowdown in growth had started in the last quarter of 2007-08 before the financial crisis hit and had its impact on India. I have argued elsewhere (Srinivasan, 2011b) that the structural problems, particularly of infrastructural constraints had made a return after the crisis to the average growth rate exceeding 9 percent achieved during the three years 2005-2008 very unlikely.

The recent decline could also be a reflection of shift from the unnecessary stimulatory policy stance earlier of RBI around March 2009 and the consequent net tightening of credit by 475 basis points through successive increases in repo rates since December 2009. Conventionally and plausibly a reduction in growth and moderation of inflation are associated with the rise in the interest rates. Also the shares of interest sensitive components of the industrial composition GDP and of aggregate expenditure are not large.

RV warned three decades ago, that in raising interest rates policy makers have to keep this trade-off in mind and adopt simultaneously other policies, particularly fiscal policies to cushion the possible adverse impacts on growth. In any case Montek Ahluwalia ended a recent interview with Karan Thapar of CNN-IBI with the frank admission that "I regret to say that I have to admit that" in response to Thapar's remark "If inflation hasn't begun coming down by February, then the Government really does not know what it is doing."(CNN-IBN Live (2011)

Ahluwalia's reasoning behind the likelihood of the current forecast of a decline of inflation by February 2012 being credible as compared to unrealized past forecasts is not persuasive. To say the full effects are yet to be felt is itself not credible. Why did the RBI not raise the repo rate in bigger steps as the signals from its earlier rises in repo rates were not felt even after the expected lag? I have already pointed out that the statement at the CII event by Governor Subbaaro defending of RBI's actual hikes was self-serving without any analytical evidence. Of course, India cannot control international prices. The possibility of their going up as well as down has to be allowed for in making forward looking policy. Did the international prices go up more than had been allowed for in the Government's March 2010 forecast? The signals about the possibility of further rise in prices were there soon after March 2010 and policy could have responded. That there is a margin of error around any forecast is obvious. For this reason, a prudent forecaster would make a point rather than in interval forecast that took forecast errors into account, is inappropriate. Moreover the observed trend in one direction (upward) only in prices suggests policy paralysis and failure and not just forecast errors.

WHERE DO WE GO FROM HERE

It is to be fervently hoped that the recent decline in weekly inflation in Food Articles would be followed by a long-awaited sustained decline in monthly rates of overall inflation. But apart from hopes and prayers, policy review, rethinking and actions are called for. Let me list some without being comprehensive and exhaustive. First, a rethinking of the framework for analysis of inflation away from paradigms largely borrowed from developed countries and towards one that is appropriate for the Indian context is needed. In particular, the fact of financial intermediation in India apparently excludes significant shares of savings and investment in GDP needs to be taken into account to assess the macroeconomic effects of the type of global financial crisis of 2008 in future. Second, the relevance to India of the foreign paradigm that monetary and the fiscal authorities pursue different objectives has to be examined without confounding it with distinct issues of independence of RBI from the fiscal authorities to set instruments under its control independently. The latter is consistent with both having the same objective for the economy with the two credibly coordinating their choices with each other. The evidence from RBI studies that there appears to be little coordination in India between them is disturbing in this context. Third, the RBI should certainly be able to transmit credibly and effectively its policy stance by explaining reasons in a forward looking manner for changes in its policy rate when it makes them. But the reasons must go beyond just for influencing short term interest rates money markets in the desired direction but more importantly for influencing one of RBI's ultimate objectives, namely sustaining growth with price stability.

RBI has not explained why its successive increases in policy rates 13 times since March 2010 have had little apparent effect on inflation. While the Annual and Quarterly reviews of the RBI of Macroeconomic Developments and Outlook are certainly valuable, they do not meet the need for explaining reasons for policy action or non-action as major shocks domestic and external hit the economy. To take just one example, RBI to the best of my knowledge has not laid out its analysis of the Euro crisis and its assessment of proposals for its resolution from an Indian perspective.

Fourth, and most important, the urgency of completing the 1991 reform agenda ought not to be underestimated. For example, fiscal consolidation, reform of the tax code, introduction of a goods and services tax, rethinking of market interventions, explicit subsidies, tax expenditures, agriculture credit, energy and infrastructure investments and policies, and also going beyond them by identifying new reforms (for example, of labour laws and state level regulations) remain to be completed or even begun in many cases. It should be understood first, that the lags in beneficial effect of these reforms to emerge would vary with the reform and the lags could be long in some cases and second, any delay in undertaking this task would avoidably keep people poor longer and prolong the inflationary trends.

Fifth, the Government and Indian society in general seem to be ambivalent about a commitment to liberalizing foreign trade and investment. On the one hand Prime Minister Manmohan Singh in his speeches at the G-20 summits supported a commitment to conclude the Doha round of Multilateral Trade Negotiation with a balanced outcome. On the other, the Commerce Minister Anand Sharma who is India's negotiator on Doha wants to go back India's position in December 2008 when India and US together contributed to the stalling of Doha Round.

Recently Singh and Sharma publicly committed themselves to the decision of the central cabinet to allow 51 percent share of Foreign Direct Investment in India's retail trade sector. Its implementation Under strong opposition, despite empirical evidence that the entry of large domestic enterprises into retailing has been beneficial to farmers and has not hurt small retailers, from Sate Governments and from political parties including from members of the own ruling coalition has led to the suspension of its implementation until a political consensus emerges. Since retail trade is under the jurisdiction of states, the emergence of a consensus seems implausible.

Sixth, fiscal consolidation to reduce consolidated fiscal deficits of the centre and states and the overall Government debt to GDP ratio to sustainable levels to support rapid and sustainable growth under price stability seems a long way off. This is primarily because the Government does not seem to have the requisite political support to reduce explicit subsidies, revenue foregone from tax exemptions and to complete fiscal reform. Clearly as compared to a desirable situation in which monetary and fiscal efforts are coordinated to maintain price stability, without support from fiscal effort, the social cost of monetary authorities alone trying to achieve the goal using its own tools would be high, assuming they succeed. But their success is by no means certain.

The global fallout from the festering Euro Zone sovereign debt crisis has already slowed the growth rate of India's exports. As happened in 2009, most likely it would again lead to a decline in exports in the near future, though it is hard to forecast the size of the decline. For well known reasons, any decline in exports has its major impact on growth of industrial production as is already happening, since a large share of India's exports is in manufactured products. In the aftermath of global financial crisis of 2008 external export credit flows and flows of Foreign Institutional Investment (FII) declined and there are already evidence of this happening now.. The recent depreciation of the Rupee could be a reflection of rationally anticipated decline in exports and FII and a rise in current account deficit. Already with an anticipated decline in its manufactured output China has already reversed its tightening of credit introduced for controlling inflation. I would not be surprised if RBI goes beyond leaving the repo rates unchanged as it has done also reverses and lowers them soon and the Government once again engages in a stimulation effort as both in 2009. But one cannot be sure since the Indian policy tradition is one of being re-active than pro-active!

Let me conclude with drawing your attention to the depth and foresight of RV's analysis of inflation and anti-inflationary policies by noting that the current Finance Minister Pranab Mukherjee in his *suo motu* statement in Parliament on November 23, 2011 said in effect the same things as RV had said in his speech presenting the 1982 -83 budget. After listing the fiscal and monetary policy actions already taken Mukherjee went on to describe what more needs to be done to check inflation, "a durable solution to inflation in an economy with rising income levels lay in improving agricultural productivity, strengthen food supply chains and augmenting capacities in manufacturing sector in pace with the growth in demand. It requires a facilitative policy environment, increased public investments so that these measures can be actively pursued". These tasks are almost the same as those in RV's policy agenda three decades ago.

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