Inflation and its discontents

Inflation only matters when the prices of goods and services increase more than incomes. If inflation went up by 10 per cent and the income of every household went up by 10 per cent, then there would be little concern on the domestic front (though if prices went up in only one country then that would have cross-border and exchange rate effects). Hence, inflation is fundamentally a distributional phenomenon, something that is well-recognised by Keynesian economists.

Unfortunately, the contemporary analytical framework used to tackle the problem — inflation targeting — does not recognise this. It views inflation principally as a supply-side phenomenon. To do this, it has to define the "potential output" of an economy. In a developed country this is the full employment (of all resources) level of output; in emerging economies, the definition tends to be more normative and astrological. The "output gap" is defined as the difference between potential output and actual output. The closer measured output is to potential output, the higher is inflation.

RATHIN ROY

To target inflation, central banks adopt a "countercyclical policy". This is done by effectively making the price of capital an administered price, while wages remain market-determined. A target inflation rate is determined, above which inflation is deemed to signal a tightening of the output gap and vice versa. Interest rates are raised by the central bank when the output gap closes, and lowered when it opens. This, very simply, is the essence of inflation targeting.

There is growing unease with this simplistic approach. From the UK to India, inflation targeting is simply not working. The Bank of England and the Reserve Bank of India fiddle with the repo rate, the former with a coherent narrative, the latter with a confusing torrent of analytical jargon sprinkled with poetry, but the end result is the same. Inflation stubbornly refuses to be amenable to the blandishments of the inflation targeting framework.

A consequence of failing to meet the inflation target is that both countries are confronting a cost of living crisis. In the UK, wages have been stagnant for a decade now in important activities like railways, education, the National Health Service and the civil service. Bankers' bonuses have risen at an alarming rate as have house prices and, recently, the prices of basic foodstuffs. The publicly funded health service is in a state of near-collapse and children in school go hungry because parents cannot afford school meals. Students start their careers on low salaries but with loans. The result has been a wave of industrial action and unrest. The Bank of England seems very detached from this reality as it huddles in its financial services bunker, fiddling with the interest rate and even pompously asking wage earners to moderate their demands. The irony and injustice of regulating the price of capital while letting wages be determined by the free market are lost on them.

In India, the situation is different but no better. The Reserve Bank of India's tinkering with the repo rate has no direct effect on the informal economy. There are few formal jobs, and wages have stagnated exactly when inflation has been elevated. The only sector boiler-plated against inflation is the public sector, which is why the demand for jobs there is so fierce, but the supply so inadequate. There are 175 million young people who are not in education nor are they looking for employment; 800 million people live below the three-dollar-a-day poverty line. For all its claims to economic glory, the majority of India's population lives immiserised, vulnerable lives, a situation that has only worsened over the past 15 years, to the extent that the government now fears to release economic data or even conduct a proper Census.

Students of India's economic history will know that "mehengai" — a state of affairs where things are unaffordable — can cause huge social and political tension. Government response is to undertake permanent relief operations, indicating that it neither understands what is driving inflation, nor has the policy capability to do anything about it. Thus, the Government of India is engaged in feeding close to 800 million people. It has slashed the food subsidy but will have to rescind that decision if food inflation persists. State governments in high inflation and (relatively) high income southern and western geographies are supplementing this with food kitchens. Government is back to interfering with agriculture, including lifting import restrictions and imposing export restrictions on different food items, and encouraging states to pause on fossil fuel taxation.

The lesson from both India and the UK is clear. Both countries urgently need to grow their economies. This requires investment and the judicious use of fiscal, monetary and industrial policy to increase productivity and output. But when inflation rears its ugly head, then social and political conflict is not far behind and the growth project gets derailed as resources are deployed to make stability payments — expenditures to avoid the conflict caused by inflation. Inflation targeting, monetary policy committees, etc. were just technocratic games that worked when inflation was not driven by structural factors or exogenous shocks. Central Banks are incapable of dealing with the political economy outcomes of inflation and the sooner this is recognised and a more joined up approach adopted, the less dangerous will be the consequences going forward.

The writer is managing director, ODI, London. r.roy@odi.org. The views are personal