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## 'Targeted subsidies to poor can check inflation better'

**D. Murali**

*In the Indian context it is unclear whether targeted subsidies to the least well-off will work effectively both because of the inefficiencies in delivery as well as the large consolidated fiscal deficit.*

Chennai Feb. 22 Inflation has been top on the agenda of our policy-makers as with the protestors of price rise. Over the last few weeks, there has been a series of measures announced with the objective of controlling inflation, directly or otherwise, such as raising the CRR (cash reserve ratio), lowering the price of petrol and diesel, banning export of milk and wheat or setting up a panel to study the derivatives segment.

"India's inflationary concerns are clearly both demand and supply driven," says Mr Ramkishan S. Rajan, Associate Professor, School of Public Policy at the George Mason University, US, commenting on the recent measures to control inflation.

"The rapid growth in demand is apparent from the acceleration in imports and consequent persistence of a current account deficit despite sharp export growth and remittance inflows," he explains. Mr Rajan answers a few questions from *Business Line*.

### **Why is the task of managing inflation difficult?**

The infusion of global liquidity has further fuelled demand growth and has made macroeconomic policies in emerging economies like India much harder to manage. In some sense this is to be expected — with open capital account there has to be willingness to accept more currency flexibility for a desired rate of monetary policy autonomy. Many emerging Asian economies are not willing to accept that — and this is in no small part due to concerns about loss of competitiveness vis-à-vis China. This said, while interest rate autonomy is compromised, there are some ways to manage the liquidity pressures via increasing cash reserve ratios or reserve requirements on banks in general (as India and China have done) and by tightening prudential regulations to reduce excess domestic credit growth.

### **How far is CRR tweaking advisable?**

While reserve requirement variations can be an effective tool, it is a very crude instrument compared to variations in the policy interest rate. In addition, reserve requirements tend to eat into banking profits and hurt the balance sheets of the banking system.

### **On how inflation is supply-driven.**

Inflation in India is also supply-driven in the sense of rising food prices. However, conventional monetary policy instruments are best used for demand-side inflation. Developing countries tend to use direct measures such as price controls, prohibiting exports of foodstuffs or reducing import tariffs on such items.

**On the effectiveness of these measures.** None of these are advisable policy options as they have distorting effects on the macro economy.

### **What are the options, therefore?**

Directed and targeted subsidies to the least well-off would be preferable, though admittedly in the Indian context it is unclear that such a policy option will work effectively both because of the inefficiencies in delivery as well as the large consolidated fiscal deficit (which in turn highlights the need to take action on this front). Over the long term, focus must also be on systemic reforms to agriculture so as to overcome inefficiencies and reduce vulnerability to monsoon conditions.

### **How does the US approach inflation?**

Given the ineffectiveness of monetary policy to combat supply-induced inflations, the way many developed countries, including the US, have recently tackled such events is to take a wait-and-see attitude and hope that the price increases are temporary. Of course, a do-nothing option could also backfire if it fuels further inflationary expectations. It is in this context that the RBI needs to consciously work towards developing a reputation for being an inflation hawk so as to reduce the possibility of self-fulfilling inflationary expectations.

### **Can India tackle inflation proactively?**

The way to do this — beyond making the inflation target more transparent — is to undertake contractionary monetary policies even if the inflationary pressures are more supply induced. The best time to do this is if the economy is already growing quite rapidly (i.e. it is not in a stagflationary situation). India is in such a position at this point. As the old adage goes — "Credibility is like toothpaste; easy to lose/squeeze out but almost impossible to regain/put back in."