What inflation-targeting?

To control rising inflation, central banks need to orchestrate their monetary policy, says ***Alok Sheel***

There is an ongoing animated debate in Indian financial dailies on the desirability of inflation-targetting as the sole objective of monetary policy. The assumption that current monetary tools are adequate to successfully target inflation is however questionable as globalisation rapidly changes the manner in which inflation is transmitted. Inflation is fast becoming an 'internationally tradable virtual commodity' over which nation states and their central banks are losing control.

According to monetarists, inflation is primarily — in Milton Friedman's extreme formulation "everywhere and always"— a monetary phenomenon. Their logic goes something like this: if money supply were constant, and the price of a particular good, service or asset (say, steel), were to rise, a fall in the demand for, and hence price of, other goods, services and assets would take place to compensate for the relative rise in demand for steel. Ceteris paribus, the rate of inflation would remain constant, because aggregate monetary demand and supply tend to equate in a market economy.

This logic however works only in a closed economy. While economies were never fully closed, goods and services are now increasingly tradable across borders. External demand and supply pulls are therefore becoming stronger. The price of tradable goods in which there is a global demand-supply imbalance could still rise despite domestic money supply remaining unchanged or even declining. The money supply adjustment would be in the non-tradable sector, which would see a decline in prices. Conversely, excess money supply is likely to inflate the price of non-tradables, especially assets like stocks and real estate, rather than the basket of tradables comprising the consumer price index.

As global trade/GDP ratios rise sharply, the price of tradable goods is increasingly determined by international, rather than domestic, demand and supply. Most of the inflation in tradable goods over the past year, in India and abroad, has been in oil, commodities and food — marked by global demand-supply imbalances. Prices of most other tradable goods are still relatively stable on account of the efficiency effects of globalisation. While the world economy taken together can be seen as closed, the role of nation-based monetary policy is becoming increasingly marginal in impacting domestic consumer price inflation.

Current inflationary expectations need to be seen against the backdrop of the remarkable price stability of the opening decade of the 21st century, combining record levels of output growth with low rates of inflation. According to IMF estimates, global output rose from an average of 3.2 per cent per annum in 1989-98 to 4.4 per cent in 1999-2008, driven by a dramatic increase from 3.8 per cent to 6.4 per cent in emerging and developing economies. Consumer price inflation in advanced economies however fell from an average of 3.3 per cent in 1989-98 to 1.7 per cent in 1999-2008. The decline in emerging and developing economies was truly astounding, falling from an average of 50.3 per cent to 6.2 per cent. While Asia saw a drop from 9.7 per cent to 3.1 per cent, the decline in putatively hyperinflationary developing economies in the western hemisphere from 134.2 per cent to 7 per cent was truly epic.

This price deflation occurred despite the Goldman Sachs broad commodity index jumping by 288 per cent over the six years to February 2008. This led to a major disconnect between consumer and commodity prices, reflected in an emerging gap between core and headline inflation. This is because core inflation indices are insulated against volatile commodity prices. It is widely believed that increasing cross border movement of goods and services muted the price effects of local demand-supply imbalances, while productivity gains deriving from the integration of huge labour markets in China and India exported price deflation over the past decade despite the huge demand generated by record growth. At the same time, huge OECD subsidies exported agricultural deflation.

On account of the disinflationary effect of globalisation on tradable goods and services excess money supply mostly impacted non-tradable assets such as real estate, or partially tradable financial assets like stock prices. This excess liquidity is commonly attributed to the burgeoning trade surpluses of developing countries on the one hand, and their consequential reluctance to appreciate their currencies on the other. Reserve accumulation not only increased money supply in developing countries, but also fuelled excess liquidity in developed countries, particularly the US, driving down real interest rates. The US real Home Value index that fluctuated within a relatively narrow range of 90-120 over the last century from 1890 (=100) to 2000, except during the Great Depression, rose sharply to touch 200 in 2006. The Dow Jones rose annually on average by 8 per cent between 2002 and 2008. Stock market inflation in developing countries was spectacular, with the Shanghai Composite Stock Index increasing by a factor of six, and the Bombay Sensex by a factor of three, between mid-2005 and end-2007.

The recent surge in commodity prices, particularly oil and foodgrain, indicates that supply side constraints have at last caught up with record levels of output growth. Emerging markets are now exporting inflation through their unquenchable demand for commodities, even as OECD countries export "agflation" by diverting food grain for biofuels. Commodity price inflation has been exacerbated by investment shifts from housing, derivatives and stock markets following the sub-prime financial crisis in western markets. *The Economist* commodity index has risen by 31.6 per cent, the food index by 60.2 per cent, and the crude oil index by 102.2 per cent over the past one year ending June 24, 2008.

If the monetary policy of nation states is being increasingly emasculated by globalisation, domestic inflation can nevertheless be suppressed by insulating the country from world markets in those tradables where there is domestic oversupply, and/or by subsidising those tradables where there is domestic short supply. High as Indian inflation rates currently are, underlying inflationary pressures are even higher for India currently seems to be doing both: banning exports of agricultural commodities and iron/steel (in which India is surplus) and controlling the retail price of POL products (in which India has a deficit). High as Indian inflation rates are, underlying inflationary pressures are therefore even higher.

Suppressing inflationary pressures cannot however neutralise the fall in the real income of the country's population consequent on the increase in the price of imports. Somebody has to bear the costs. In the case of food and metals, producers pay the price. In the case of POL products, the cost of subsidies is eventually borne by the general taxpayer, either in this generation or the next. It is, of course, possible to shift the fiscal burden of subsidising imports to exporters, particularly import-intensive exporters, by appreciating the exchange rate.

As for monetary policy, a restrictive stance could impact inflation on the margin by preventing higher import prices from working their way into higher wages and into general domestic prices. However, to make a meaningful dent on hyperinflation in a rapidly globalising world, developing and developed country central banks, in particular the US Fed that continues to follow a loose monetary policy, need to orchestrate their inflation targeting.

The writer is a civil servant. Views expressed here are personal