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Onions Minus Tears

Increasing supply best way to control inflation

The price rise in food articles — onions, fruit, milk, vegetables and pulses — is really starting to hurt. Ruling at about 20 per cent over the same period last year, food prices are driving the present inflation of 6.7 per cent. Let us cut through the babble of economists, politicians and bankers and try to figure out why prices are rising and where economy managers are making mistakes. Is the current inflation essentially caused by too much money chasing too few goods, as the Reserve Bank (RBI) would have us believe? RBI raised short-term lending rates for banks six times since April 2005, but that has had little effect on the growth of credit. This is not surprising because in an open economy with growing financial flows banks can access credit at competitive rates from other sources. RBI has, therefore, resorted to a more drastic move: raising the reserves that banks need to keep with them by 0.5 per cent since January 1 this year to 6 per cent of its deposits. This would make money dear for manufacturing, which, in fact, is not principally behind the current price rise. It is very unlikely that high money supply and credit growth have contributed to a rise in prices of foodstuffs. Their prices have risen because production has not kept pace with demand. So what is RBI trying to achieve? By making money dear, it will exacerbate supply constraints in manufacturing and create inflationary conditions in this sector. RBI should be reconciled to high money supply growth in an open and rapidly growing economy. It should restrict itself to easing credit in order to promote productivity and innovation.

India's focus ought to remain on high growth, even if that entails an interim inflation level of 5-5.5 per cent — interim, because that would come down when supply side constraints are eased. Attacking inflation too hard through interest rate hikes would hit growth and jobs. Does this prescription sound harsh for those doing their grocery shopping? Not really. Their immediate problems can be solved through imports, while the real challenge lies in doubling the trend growth rate of agriculture from 2 per cent to 4 per cent. The government has done too little, too late by reducing petrol and diesel prices by Rs 2 and Re 1 a litre, respectively. Petrol prices can be cut further if the government slashes the tax component. What else can it do to ease structural constraints to growth? The government should make India an easier place to do business by attacking the red tape and cutting expenditure that does not create assets. With such steps, we can have jobs and growth with low prices, our onions without tears.