Pandemic Inflation: A Menace to Tame for Developing Countries?

India and other developing countries are currently faced with the twin challenges of economic revival in the midst of the Covid-19 pandemic, and increasing inflation. Moreover, global economic recovery might prove to be detrimental for a developing country's economy, contrary to popular narrative. Anand B. and Shreya Gulati argue that in the face of such challenges, these countries need to walk a tightrope between accommodative and tight monetary policy.

The relentless fight against the spread of Covid-19 continues, ever since the first case was reported in Wuhan. However, lack of resources and inadequate healthcare facilities has made this battle extremely challenging for developing/emerging economies compared to their developed counterparts. Already struggling with subdued economic activity and huge revenue depletion, policy makers in emerging economies are contemplating another economic danger in the form of inflation. According to Bloomberg's survey of economists, the estimated net change in inflation outlooks for 2022, compared to the 2021 Survey, is considerably higher for many developing economies. This is sharpest in the case of the Chinese economy, followed by Indonesia, Vietnam, Japan, Hong Kong and Sri Lanka.

The Indian story is not different. India's retail inflation in May 2021 has risen to 6.30% (year on year), which is the highest in the past six months. The major triggers are lockdown-induced supply disruptions during the second wave of the pandemic, and a sharp increase in the retail fuel prices owing to higher taxes on petroleum products. Further, the latest (70th round) Survey of Professional Forecasters (SPF) on Macroeconomic Indicators conducted by the Reserve Bank of India (India's central bank) indicates that the economy's inflation expectations are likely to remain high. This puts policy makers in a conundrum — on the one hand, economic recovery and growth necessitate the use of accommodative monetary policy which increases the money supply and reduces interest rates to propel spending for economic growth. On the other, inflationary pressures make the use of tight monetary policy which reduces money supply and increases interest rates prudently. This implies that the ability of the Reserve Bank of India to continue with the accommodative monetary policy in the future will be significantly reduced if the actual inflation and the inflation expectations consistently hover around the upper band of the bank's inflation target.

Global Recovery: Boon or Bane?

Apart from these domestic factors, emerging economies including India have been closely and cautiously observing the process of global recovery. Ironically, from a developing economy's point of view, fast-paced global recovery (and consequent inflation) should have been welcomed with great optimism and zeal. So, what could the problem be? The major issue is that rising inflation in developed economies (especially in the US) significantly influences investors' expected rates of interest, which will subsequently push the bond yields upwards, a scenario that the developing economies wish to avoid as it will cause them to pay higher interest rates in the debt market. Also, the US economic recovery can result in a huge outflow of portfolio investments from these countries causing massive financial sector instabilities.

However, compared to other developing economies, India has at least three advantages that make the country less shaky in case of capital outflows. One is that 2021's refinancing requirement of India stands at 3.3% of GDP, which is considerably lower than other emerging economies like Russia, Brazil, South Africa, Turkey and Egypt. Second, India mostly depends on its domestic front rather than on foreign lenders for its borrowing needs. Finally, over the past 30 years starting from the economic liberalisation in 1991, the Reserve Bank of India has amassed a comfortable cushion of foreign exchange reserves (amounting to a whopping 610 billion US Dollars). On the fiscal side, evidently India will be relying heavily on the borrowing route to revive its deteriorating economic condition. This is crucial to regain the pace of economic growth in the medium- to long-run and boost private investments. As mentioned earlier, the rising inflation and yield curves in advanced economies can impact the cost of borrowing and debt sustainability. In such a scenario, economic revival via the fiscal route is likely to be constrained. Thus, the remaining option of liquidity injection to the economy is the monetary route. However, at a time when the 'animal spirits' have hit rock bottom, even substantial policy rate cuts may prove futile. Hence, prima facie it is evident that monetary policy cannot single-handedly combat unprecedented exigencies like these.

Another Great Depression in the Offing?

If there is a panacea to fix the deep dent in the global economy caused by the pandemic, it is the adoption of expansionary fiscal policy supported by accommodative monetary policy, a leery balance, difficult to strike. Nevertheless, the rising inflationary pressure has already resulted in monetary tightening in many emerging countries. For instance, Brazil has hiked policy rates twice this year. Quite unexpectedly, Mexico's central bank increased the policy rates to 4.25% in their last board meeting. The Central Bank of Russia has increased its benchmark rates to 50 basis point and warned that they might go for further tightening if inflation does not moderate. Most likely, India's central bank will also be following the same path and hike the interest rates soon to keep the inflation under check.

To what extent might such a policy shift affect a country's economic growth? The answer remains nebulous. However, past experiences show that monetary tightening will certainly be detrimental for economic growth in times like these. Does that mean we are inching towards something as grave as the Great Depression of the 1930s? Not necessarily, because a considerable portion of the sudden spurt in inflation in most countries is primarily due to three reasons: first, the 'low base effect' from the previous year, the repercussions of which can be reversed, concomitantly lowering the headline inflation once the base starts to normalise; second, the lockdown-induced supply disruptions, which are expected to emend with the vaccines gaining ground and people reverting to normal life — if the packed stadiums witnessed during the Euro 2021 in some European venues and Norway's declaration that 'Covid-19 is Over' can be taken into consideration, at least an optimist will expect that 'normal life' is slowly but steadily being restored in parts of the world (assuming that the Delta variant will not be lethal). Last, there is a huge pent up demand that exists across the world — the sharp reduction in household-spending during the spate of lockdowns and similar restrictions is slowly getting reinstated. This means the involuntary unemployment is likely to be moderated.

Policy Options for India

In the Indian case, it may take a little more time to declare ‘normalcy’, considering the socio-economic and geo-political diversity of the country. The scenario may improve as a majority of India’s states have initiated the lifting of lockdown after the second wave. At the moment, India’s immediate concern is boosting GDP growth while maintaining price stability. Once the supply constraints are removed, consumer prices will be stabilised to a greater extent. However, this is only half the story; unless the retail fuel prices are reduced, inflation and (more importantly) inflation expectations cannot be curbed effectively. Thus, high taxes on petroleum products should be reduced immediately, which can be carried out both at the central and state levels. However, the large chasm between revenue and expenditures prevent the majority of states from forgoing the income accrued from the state-specific taxes levied on petroleum products. So, at the end of the day it becomes the call of the central government. Many economists have suggested that bringing petroleum products within the purview of the Goods and Services Tax net (GST) would be a feasible policy option in this regard. Further, the economy may still witness (in fact it *has* witnessed) surge in core inflation (a measure which excludes transitory components such as food and fuel products) due to the influence of pent up demand leading to a mismatch between actual output and potential output of the economy. But this will mostly be a short term phenomenon that gets corrected in the medium to long term when the economy’s potential output picks up.

In summary, inflation has resurfaced both at the domestic and the international level, leaving less leg room for the monetary authority to operate. Central banks face a tightrope walk between accommodative and tight monetary policy, making monetary policy an extremely tricky business. In India, oscillating and alternating between accommodative and tight monetary policy in varying degrees can help to revive the economy while taming inflation.

The views expressed here are those of the author, and not of the ‘South Asia @ LSE’ blog, the LSE South Asia Centre or the London School of Economics & Political Science.

Banner image © ‘Saints don’t live on Park Avenue’ by M.B.M, Unsplash.

Date originally posted: 2021-10-25

Permalink: https://blogs.lse.ac.uk/southasia/2021/10/25/pandemic-inflation-a-menace-to-tame-for-developing-countries/

Blog homepage: https://blogs.lse.ac.uk/southasia/