Deficit Financing, Inflation and Price Control

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—A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

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By

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Today, the prices of all commodities, specially those of mass consumption, have risen alarmingly, disrupting the budgets of millions of poor and middle class families. Within a single year, prices have risen by over 22 per cent, the highest recorded in recent times. A significant feature of price behaviour since 1972 has been the pronounced increase in the prices of food articles (e.g. edible oils, vanaspati, sugar, foodgrains etc.), accounting for over two-thirds of the total price rise. Some other necessities such as vegetables. bananas etc. cost even more. Industrial raw materials are up by over 30 per cent. What hurts the common man even more than the alarming price rise is the fact that even at these high prices, the basic items of daily use are getting out of his reach, while for those that are available long waits in queues are the rule. Anti-price-rise demonstrations, which have become the order of the day, are fast deteriorating into lawlessness. What is worse, the Government's pricing policies are themselves adding further to the price rise. The recent decisions to allow increases in the prices of vanaspati, coarse and medium cloth and petroleum products are cases in point. Thus, the real earnings of workers and other fixed income groups are getting eroded fast, while profiteers and hoarders appear to be exploiting the situation to the maximum. As is rightly said, "Inflation is confiscation without compensation. The victims are deprived of their purchasing

* The author, a retired member of the Indian Economic Service, was formerly Director of Review and Research, Tariff Commission. This text is based on a public lecture delivered under the auspices of the Forum of Free Enterprise in Bombay on 25th July 1973.

power. This is. in fact, robbery on national scale. It penalises the saver especially and the honest producer, while the lucky operator and the political manipulator reap unearned reward."

Indeed, price inflation has been with us for quite some time. Price rise, between 1950-51 and 1962-63, was fairly mild, not exceeding, on an average, two or three per cent a year. The situation changed drastically thereafter. The large spurt in Government expenditure both on account of defence and development, the persisting food imbalance which was only partly offset by large food imports, the rise in money wages which became progressively tied to the cost of living index and the consequent rise in industrial costs, which was further accentuated by the devaluation of the Rupee in 1966 on account of the increased rupee cost of imported raw materials and of the servicing of foreign debts and liabilities, and above all, the slow growth rate of national income which was just maintained at the level reached in earlier years till 1964-65 but became negative in 1965-66—all these factors accelerated the price rise by 30 per cent between 1962-63 and 1965-66 and by a further 16 per cent and 11 per cent respectively in 1966-67 and 1967-68. To meet this situation, the tax-income ratio was raised but was not adequate for the purpose. Government investment was reduced in 1965-66 and was kept low thereafter. This affected private investment also and slowed down industrial output. The degree of under-utilisation of production capacity rose sharply, the unemployment situation deteriorated and the investment climate worsened. Still, the sharp downward fluctuation in foodgrain output in 1965-66 and 1966-67 kept up the inflationary spiral. The lag in agriculture was hardly amenable to control via monetary-fiscal policies. And so, inflation persisted and brought in its wake a paradoxical situation—the so-called industrial recession which hit certain specific industries like the engineering industry. It was only in 1968 and later that the two consecutive good harvests and larger food imports softened the spiral effects. Even so, prices rose by about 5 per cent in 1970 as also in 1971 and the success claimed in the agricultural front—the so-called "Green Revolution", did not arrest price inflation which was the cumulative result of excess demand caused by investment exceeding saving, the inflow of resources from abroad and the foreign exchange constraint preventing imports which could have softened the impact of excess demand. These, together with the unavoidable defence expenditure in 1971 followed by severe drought conditions in most parts of the country and the consequent abnormal increase in money supply (which rose between 10 to 14 per cent in 1972 over and above the rise of the order of 13.9 per cent in 1971-72), led to an increase of 14 per cent in the wholesale price index during the 12 months ending December. 1972.

The most disturbing factor has been the order of deficit spending resorted to by the Central and State Governments in 1972-73 at the time of the failure of crops and sluggish growth in industrial output. Net bank credit to the Government sector as at the end of the second week of January 1973 increased by Rs. 1207 crores in comparison to the corresponding period of 1972, while the growth rates have been dismal. National income slumped to 4.7 per cent in 1970-71 from 5.3 per cent in the previous year. "The Economic Survey" presented by the Union Finance Minister to Parliament on February 22,1973, pointed out that agricultural production declined by 1.7 per cent in 1971-72 as compared to 1970-71; in particular, food production declined by 3.4 per cent over the year while industrial production which went up by 6.6 per cent in 1969-70 and by 2.5 per cent in 1970-71, recorded a growth rate of only 4.5 per cent in 1971-72. For the year 1972-73, the growth rate as visualised by "The Economic Survey" may be somewhat lower than 7 per cent. It is an open question whether even this rate would be realised in view of the serious power shortage faced by industry, practically all over the country.

It is no wonder, therefore, that in summing up the immediate causes of the current inflationary spiral of the run-away kind, the Governor of the Reserve Bank of India, in his letter dated 30th May, 1973, to all scheduled banks announcing the Reserve Bank's new credit squeeze, said thus: "While production losses, particularly in the agricultural sector, have been an important cause of the spurt in prices, continued heavy budgetary deficits have also contributed to the increase........ Money supply with the public is now over 16 per cent higher than last year's level........... Budgetary measures, particularly greater control over public expenditure, should provide the primary corrective." Far from this happening, according to the startling disclosures made by the Finance Minister in the Rajya Sabha on the 24th July 1973, deficit financing in the first tnree months alone of the current financial year (1973-74) had been of the order of Rs. 380 crores (nearly 45 per cent of that in the whole of 1972-73) as against only Rs. 75/- crores estimated for the whole year in the Central Budget for 1973-74. No wonder, the wholesale price index rose by 22.3 per cent on July 21, 1973, as compared with that on July 22, 1972.

In these circumstances, how do the increase in the Bank Rate from six to seven per cent and other measures for overall credit restriction announced by the Reserve Bank meet the situation? Using the interest rate as an anti-inflationary device was suggested by Keynes long ago. An increase in rediscount rates tends to increase the cost of borrowing funds for business and consumer spending and thus discourages excessive activity based on borrowed funds. Ours, however, is not much of an organised economy such as exists in the U.K. or U.S.A. and a very large part of the credit still falls outside the monetary sector. Moreover, a one per cent increase in the rate of interest may not seriously affect those who invest from borrowed resources. There can still be profitability at higher rates of interest. Keynes himself recognised the limitations of the re-discount rates as a weapon to check an inflationary boom as under:—

(a) If the bank rates (i.e. interest rates on loans charged by commercial banks) do not rise *pari passu* with the rise in rediscount rates leading to no decline in consumer spending:

(b) If the commercial banks which are in possession of large amounts of short-term Government securities increase their reserves with the Central Bank or by converting the maturing securities into cash. instead of borrowing from the Central Bank at higher rediscount rates; and

(c) If non-bank holders of Government securities (e.g. insurance companies etc.) are to convert their holdings into cash which will have the effect of increasing the velocity of money consequent on increased cash balance. At a time of rising prices and falling value of money, there is, indeed, a strong temptation on the part of holders of fixed income yielding assets to convert them into cash.

That the rise in Bank Rate and other measures announced by the Reserve Bank to impound bank funds have not succeeded in their purpose is clear from the figures of bank credit, cash reserves and investments compared to corresponding period of the previous slack season. Ordinarily, a rise in the bank rate without a simultaneous increase in the general lending rates makes no sense. But in a highly inflationary situation. trade and industry will be sorely tempted to borrow funds in order to build up inventories even if the lending rates are high by two or three per cent. This points to the need not only for curbing lending by the commercial banks to the non-priority sectors, but also for taking immediate steps to encourage private savings by substantially increasing the interest rates payable on bank deposits. The argument that there is no need to do so because bank deposits have already swelled to over Rs. 9200 by now and that they have been rising by as much as about Rs. 140 crores a month. on an average, during the past one year is not sustainable. For, the increasing deposits do not reflect real savings but massive deficit financing by the Government. The savings rate no doubt increased from 8.2 per cent in 1968-69 to 8.6 per cent in 1969-70, 9.4 per cent in 1970-71 and to 10 per cent in 1971-72 and is expected, in 1972-73. to be somewhat higher than in 1971-72 based on the growth of financial assets: still it is not much higher than that reached in the early sixties. A fillip to deposit mobilisation, combined with effective measures to mop up the surplus resources of the banks can, indeed, go a long way. towards restricting the money supply with the public and also help remove the inflationary pressures on the prices of goods and services.

Inflation may be caused not only by deficit financing by Government at a rate faster than that of the growth of goods and services in the economy but also by diversion of productive resources (bank credit) to non-productive or speculative sectors.

Expansion of bank credit unrelated to the genuine short-term needs of industry, however, tends to hurt the economy in two ways: (1) by diverting funds to unproductive ventures or speculative build-up of essential goods in short supply, thus causing distortions in the economy and contributing to the inflationary spiral; and (2) by depriving other priority sectors of the economy of essential credit.

In an inflationary situation such as exists today, one's rhoughts naturally go to price control as an instrument of keeping down prices. The rationale behind price control is two-fold, namely, (1) to enable the user industries to purchase basic inputs such as steel, coal, cement etc., at reasonable prices and in adequate quantities, so that the necessary infrastructure of the economy is built up quickly and efficiently; (2) to maintain a reasonable degree of price stability in factor prices and commodity prices, so that a cost-push demand-pull inflation does not stifle economic growth. Price control, as it has operated in our country, so far, has failed in attaining both these objectives.

Pricing policies followed in India so far, as the A.R.C. Working Group on Developmental, Control, and Regulatory Organisations (1968) has averred, have been merely *ad hoc* adjustments to the immediate requirements of a particular price situation, individual prices being fixed without any attempt to make them fit into a rationalised pattern even for a short-term.

Presently, the price structure of the Indian economy is determined neither by the forces of a competitive market nor, in their absence, is the structure being moulded on a well-conceived long-term strategy. This has resulted in what is called ***ad hocism*** and the entire field is subjected to so many pressures and pulls of interested groups that the emerging pattern has no relationship whatsoever with the underlying economic conditions and the needs of the economy as a whole. "In this set-up which virtually amounts to a sort of enforced market-sharing, it is not surprising that the domestic producers have no incentive for achieving optimum efficiency of production. There is no particular urge to reduce the costs. The lack of cost consciousness in our economy has almost reached alarming proportions. Over the years, no national pricing policy or pricing system has been evolved and no price stability (achieved) based on the efficient functioning of the economy."

A well-administered price control can, indeed, be a useful device in dealing with conditions of ***temporary*** shortages. ***A*** well-administered price, however, must include control over distribution and consumption as well. Price control which is effective only at the producers' level while leaving distribution and consumption free, penalises the honest producer, rewards the black-marketeer, enriches the middleman and gives no relief to the poor consumer.

In view of the difficulties in controlling prices, distribution and consumption at the same time, it is wise to be selective in imposing control. Even so, in a system where industries and prices are held in close inter-relationship, the success of price control depends not on that of one or the other commodity, but of all inter-related commodities. For example, not long ago, the sudden spurt in raw rubber prices **led** to a rise in the price of rubber tyres and tubes, which in turn was passed on to the automobile industry forcing it to claim a higher price for automobiles.

A typical example is the price of steel, a strategic product, having its impact on the cost and price structure of a wide range of products in the economic field. India's steel at one time was one of the cheapest in the world. But it is perhaps not so cheap now. Price control, therefore, although apparently covering only a relatively few commodities either on account of their strategic importance or because they have displayed considerable disequilibrium between demand and supply, really sets standards in pricing which have their impact on a much wider field in the economy. An integrated view of pricing is, thus, of paramount importance.

Distortions, however, do take place when prices are half-controlled and left half-free, as, for example, when the price of the end-product is controlled, leaving that of the raw materials free. A case in point is that of Vanaspati. The recent price hike announced in respect of this product is attributed to the abnormal increase in the price of groundnut oil, the principal raw material accounting for 80 per cent of the cost of Vanaspati, which is, however, left free. This really amounts to penalising the consumer, for, despite the world shortage of oils, we can still import these at prices cheaper than the domestic prices of ground-nut oil in India. Import restrictions and foreign exchange constraints come in the way. All too often, when shortages develop, whether of foodgrains or of steel or any other product, the foreign exchange constraint prevents us from resorting to imports. It is only when the situation really becomes bad that foreign exchange begins to get released. By that time, prices have risen further and it is difficult to bring them down. If the same foreign exchange which eventually is released for such imports had been released in time, the damage could have been avoided.

The more serious objection to price control. however, relates to the mechanics and methodology of pricing, generally known as the "cost-plus" basis. This, as the late Prof. D. R. Gadgil had said, has been the most costly way of enforcing price control. High costs are. indeed, inherent in an oligopolistic economy, and unless there is a very strong urge on the part of industry for innovation and improvement for cutting down costs, there is no escape from the high-cost economy where there is a bias towards the seller's market. Costing looked at in a purely static way would

not help improvement or change. **The fact remains that over the years no norms or techniques of costing have been evolved by price fixing authorities, by which both the producer and consumer would stand to gain by cost cutting.** During the protection granted to India's steel industry, for example, the Tariff Board (processor of the present Tariff Commission) not only went into the costs at the moment but also projected the sort of capital and other improvements that the industry should make during the period of protection. There was thus continuous pressure on the industry to do better. In the absenc of such pressure, unless there is a strong internal urge, the tendency is for the units to stagnate. In other words, what is required is cost-audit, a projection of what can be done, and unless this is done the gap between individual and social costs is bound to get widened. A good pricing system in India should aim at narrowing this gap as much and as quickly as possible.

The "cost-plus" basis of pricing, however, geared as it is to the higher production cost of inefficient marginal units. far from giving the consumer the benefit of price reduction and making the producer cost-conscious, tends to inflate costs and prices (at least, it gives no incentive to keep costs under control) thanks to the continuing scarcity and lack of competition. This method of pricing is clearly inflationary and particularly unsuitable in the context of the need to offer price competition in overseas markets where alone the efficiency of a product in terms of cost and quality is ultimately determined.

One more effect of price control, ironically enough, is to make priority products (e.g. steel) less profitable inasmuch as non-priority products are left free of control, thus encouraging investment in these non-priority products, which is indeed contrary to the objectives of price control. If basic industries earn well, more could be invested in them and shortages would disappear. In this connection, one cannot but quote with approbation what Mr. J. R. D. Tata has said in the Sixty-sixth Annual Report (1972-73) of the Tata Iron and Steel Company Ltd. as under:

"I only ask that, at long last, our Government recognise the following realities of economic life:

"That our current inflation does not flow from the prices of basic industrial products;

"That the cure for inflation, therefore, does not lie in denying economic prices to core and priority industries;

"That a fair return is as essential to promoting increased production and efficiency in basic industries as in any other industry;

"That to deny such industries the wherewithal to maintain increased production can only result in more intensified inflation due to more intensified shortages;

"That pricing policies which starve priority industries of their basic needs, while allowing high profitability and therefore easy access to unlimited finance to non-priority industries, make no economic sense;

"That such policies can only intensify scarcities in essential materials which benefit neither the producer in terms of a fair return on capital nor the consumer in terms of fair prices, nor Government in terms of growing tax revenues."

Price inflation has brought in its wake among other ill-effects, "perverse income shifts" as Prof. B. R. Shenoy calls them, "feeding luxury" living by the few at the expense of food and, other daily necessities of life for the masses. "The inevitable efforts to circumvent controls." as he rightly says, "have interrupted the free flow of supplies, enhanced the distribution costs, and, therefore, the price actually paid by consumers, swollen the middlemen's profits at the expense of producers and consumers, and to the extent that producers receive but controlled prices, impinged adversely on the production of the commodities concerned, accentuating the problem which price controls seek to remedy". The present policy of price control is thus based neither on the essentiality of the goods controlled from the angle of mass welfare nor on the possibility of siphoning off excessive profits arising from closed markets to the public exchequer nor on

the forward and backward linkages of the commodities sought to be controlled. This policy has inevitably led to the emergence of buoyant black markets in commodities which can by no means be considered as entering into the sphere of mass consumption. For price control, therefore, to be effective in bringing the inflationary earnings more easily into the public exchequer, it would be necessary to raise the retention price allowed to the producers of priority commodities, so as to induce them to produce more of these goods and also make available the necessary inputs for producing them. Correspondingly, the indirect taxation on non-essential goods may have to be raised suitably so as to prevent further investment in them and help to divert such investment in more essential commodities. In the ultimate analysis, this is the only way of removing shortages, black markets and price inflation.

To sum up: Experience has shown that the prevailing critical situation cannot be tackled with monetary and fiscal policies alone. "In Indian conditions," as a former Governor of the Reserve Bank of India, Mr. L. K. Jha, has said, "if there is abundance of foodgrains, a great many risks can be taken on the fiscal and monetary front without an inflationary upsurge in prices, while if there is a shortage of foodgrains not all the fiscal and monetary restraints can hold the price line." Growth, no doubt, is basically anti-inflationary in its impact, but if investment is pushed up to a level well above the level of savings in the community, inflationary force can be generated by growth. Monetary expansion to keep pace with the increased availability of goods and services resulting from growth may be consistent with price stability, but **what is dangerous is the belief that deficit financing is a substitute for, rather than a supplement to, resources mobilisation.** The pattern of investment has a special significance in an economy such as ours where the shortage of basic necessities, specially foodgrains, has been a more potent cause of inflation than monetary expansion.

One hears these days of Government's thinking in terms of an Incomes Policy, designed to regulate not only wages but all other forms of income as well, including profits, rents and dividends. In the context of the Government's failure to control prices and its own expenditure and to eradicate the evil of black money which continues to play havoc with the price structure, it is futile to expect that workers or white collar employees will accept a wage or salary freeze, and much less agree to a moratorium on strikes. During the past 12 months alone, while prices have shot up by as much as over 22 per cent, wages in certain sectors of organised industry have gone up by only eight to ten per cent and in others, not at all. This shows that in Indian conditions the link between wages and prices, even if it exists, is pretty weak and erratic. In any case, wages account for a mere six per cent of the gross national product, the rest being contributed by farm production, the out-put of self-employed artisans, trade, services and the like. Besides, wages form only 1/5th of the total cost of most commodities, and this ratio has been static over the years. The most obvious remedy for the existing ills, therefore, is to maximise production and this can be best ensured by linking the wage increases with productivity, better management practices and the elimination of red-tape in the grant of licences and permits to industrial units. Besides, an all-out drive to restrain conspicuous consumption and unearth black money, control non-productive expenditure, whether of Government or Industry and streamline the procurement and distribution of essential commodities will have a healthier impact on wages and prices than a policy designed to control and freeze wages, prices and incomes. For, as a leading journal in Great Britain, "The Accountant", has stated recently: "In a market economy in which prices of goods and services are ultimately determined by the forces of supply and demand, any intervention by Government in the form of fixing or holding prices and incomes cannot for long be effective. Even in an economy in which all goods and services are rationed and the factors of production controlled, the forces of supply and demand will ultimately make themselves felt .... *There is no golden rule to success in the battle against inflation."*

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—Eugene Black

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