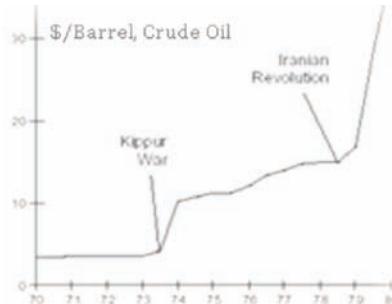


UNDERSTANDING STAGFLATION

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"I have directed our New Council on wage and price stability to find and expose all restrictive practices, public or private, which raise food prices"

U.S. President Gerald R. Ford,
October 1974



VIVEK MOORTHY

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Double whammy for RBI: Retail inflation surges, IIP contracts

Business Standard
Dec 2013

Russia Is Facing Stagflation, Central Banker Says

Wall Street Journal
Jan 2014

HSBC Says Turkey Heading for Stagflation as Lira Drops

Bloomberg
Jan 2014

Govt increases railway fares by up to 25%, after a decade

Business Standard
Jan 2013

"The Downsizing of Idlis and Vadas",
Bangalore Mirror
March 2013



UNDERSTANDING STAGFLATION

PAST & PRESENT

VIVEK MOORTHY

PROFESSOR, ECONOMICS AND SOCIAL SCIENCES AREA
INDIAN INSTITUTE OF MANAGEMENT BANGALORE (IIMB)
BANGALORE, INDIA



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About The Author

Vivek Moorthy is a Professor in the Economics and Social Sciences Area. He obtained his Doctorate at the University of California at Los Angeles. At IIMB, he teaches core and elective courses in Macroeconomics and Financial Markets. Prior to joining IIM Bangalore, he was with the Federal Reserve Bank of New York (FRBNY). After joining IIM Bangalore in 1995, he has been Visiting Professor at University of Ottawa, Canada; Jawaharlal Nehru University, New Delhi; National Institute of Public Finance and Policy, New Delhi; Sciences Po, Lille, France and Claremont Graduate University, California.



A macroeconomist, his interests range across monetary and fiscal policy, global financial markets and banking, with a focus on public policy. His thesis and early research was on labour market aspects of business cycles, and his findings on unemployment insurance were prominently cited in the Canadian press. He worked on U.S. economy forecasts in the Economic Projections Division and has authored and coauthored FRBNY staff studies and reports on monetary policy targets, foreign exchange and financial market developments.

His international and Indian journal publications have been mainly on interest rates and exchange rates. He was the principal author of a 2000 study for the Reserve Bank of India on India's public debt. Academic publications apart, he has written in various newspapers and magazines in India and abroad – in particular, the Economic Times, Mint, Financial Express, the Far Eastern Economic Review, and the Wall Street Journal – on macroeconomic issues, and on transportation.

He is finishing up a textbook titled *Macroeconomics: An Integrated, Financial Approach* for use at the intermediate undergraduate, Master's and MBA level. The table of Contents and Salient Features of the text are outlined in his website economicsperiscope.com, mainly a chronological list of publications.

Preface to This Book and Guide for Readers

To begin with, the main motivation in writing this book is to explain the largely misunderstood phenomenon of stagflation, which, at present, India and other emerging economies are facing. The macroeconomic textbooks that are widely used fail to adequately analyze the 1970s stagflation. Further, the major textbooks generally do not cover emerging economy macroeconomic issues and problems, of which the ongoing stagflation is a major one.

This book explains both the US stagflation of the 1970s as well as the ongoing stagflation. This explanation is based on an approach I have been teaching here at the Indian Institute of Management, Bangalore since 1995. The content of Part One of this book largely comprises Chapters 5 and Chapter 6 of the main text that I am writing (*Macroeconomics: An Integrated Financial Approach*). Henceforth this main text is referred to as **MIFA**. This much smaller book *Understanding Stagflation: Past and Present*, I will refer to as **USPAP**. Please keep these acronyms in mind.

While a text is meant mainly for students and tends to be formulaic, this book is meant for a wider audience – in particular, all those who have been interested in and have been following the Indian economy for the last several years or more. In particular, various economists, policy makers, journalists, some CEOs, management consultants, equity analysts and fund managers should (hopefully) find that this book provides the vital analytical foundations to examine their specific topic of interest.

A macro text deals with a wide range of topics, stagflation is just one of them. The major common topics are:

- (i) GDP accounting, the components of GDP and their determination,
- (ii) Various aspects of the Depression and 2008 crisis – the role of asset bubbles and then deleveraging.
- (iii) The Keynesian multiplier concept and fiscal policy to counteract recessions, deficits and debt.

- (iv) The whole gamut of monetary policy – the multiple expansion of credit and money supply via the banking system, money multiplier formulae, instruments, targets and goals of monetary policy.
- (v) Open economy – Balance of Payments and its links to GDP and money supply data, the impact on exchange rates and interest rates and forex reserves of capital flows, associated capital account policies.
- (vi) The labour market and the real sector: the expectations augmented Phillips curve, which I call the Inflation Adjusted Phillips Curve (IAPC). Within this topic, supply shocks and the ensuing stagflation.

Although all of the above topics are covered in the widely used textbooks, the last topic (vi) does not get the attention it deserves. Going through recent policy documents of central banks in emerging economies, it is evident that the variables and coefficient values discussed mostly pertain to output gap and inflation expectations. In macroeconomics, the IAPC should be given more emphasis relative to the other topics, which this book does.

In Part B, there is a large amount of factual detail here pertaining to economic outcomes in India and other emerging economies. It cites at length and critiques various policy makers and influential economic commentary. Nevertheless, this is not a book about the Indian economy, as the following discussion clarifies.

Macroeconomics as a subject lies somewhere between physics with universal laws and say, political history, which is mostly country specific documentation and narrative. There is no such thing as Indian physics and it would be absurd to write a book about it. One must ask: does it make sense to write a book or teach a course about the Indian economy? There is no clear answer to this question.

In my opinion, the suitable approach for macroeconomics is somewhere in between: to explain the broad principles, drawing upon economic history. An analogy may help explain my approach. A seismologist could write a book about soil formation and earthquake risk in the Terai region, with enormous detail about local conditions. But the book itself must be rooted in principles of seismology, and not be a mere accumulation of Terai topsoil. The assessment of earthquake risk would be convincing if it uses evidence from soil in another continent. Similarly the analysis of stagflation would be valid if it holds in other countries and periods. What this book is meant to do is explain stagflation outcomes using principles of classical macroeconomics, with detailed evidence about USA and India.

A related purpose of this book is to raise the level of macroeconomic understanding in India (and perhaps some other emerging economies). India's economy has been greatly liberalized since 1991 – indeed, one can argue that the external financial sector has been over-liberalized. Nevertheless the macroeconomic views of the liberalizers and the media are pre 1991 and mostly Keynesian. Inflation is generally considered to be a problem of food inflation and due to food supply shocks, contrary to the classical view developed here. If this book succeeds in making policy makers and the various economists and commentators who influence them understand and accept classical macroeconomics and associated policy recommendations, it will have contributed to improving India's economic performance in the years ahead.

This e-book version has been completed up to Chapter 5. For students using this in my course, this table below provides a guide to connect the Detailed Table of Contents for this book (USPAP) with the Table of Contents for the bigger book (MIFA), provided at the end of this book.

A special acknowledgement is due to Anupam Manur, my research associate, for his outstanding help, without which this book would not have been completed. I also thank Shrikant Kolhar, my former doctoral student, whose research on food prices have been incorporated into this book.

Corresponding Sections of USPAP and MIFA

Chapter Number in USPAP	Location in Bigger Text MIFA
Chapter 1: Speeding Along the GDP Autobahn	Not Applicable
Chapter 2: Building the Framework for Macroeconomic Analysis	Parts of Chapter 1
Chapter 3: The Phillips Curve and Inflation	Identical to Chapter 5
Chapter 4: Cost Push, Demand Pull and Stagflation	Identical to Chapter 6 (Part A)
Chapter 5: Dissecting India's Ongoing Stagflation	Identical to Chapter 6 (Part B)

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Comments, criticism and general feedback, from one and all, are welcome.