Source : www.thehindu.com Date : 2022-05-11

CONTROL INFLATION BY ACTING ON LIQUIDITY

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

‘Inflation has assumed a menacing proportion in almost all countries’ | Photo Credit: Getty Images/iStockphoto

The recent action of the Reserve Bank of India (RBI) to raise the repo rate by 40 basis points and cash reserve ratio (CRR) by 50 basis points is a recognition of the serious situation with respect to inflation in our country and the resolve to tackle inflation. Inflation has assumed a menacing proportion in almost all countries. The situation is the worst in the United States where the consumer price inflation stood (in March 2022) at 8.56%, a level not reached for several decades. Consumer price index (CPI) inflation in India stood (in March 2022) at 6.95%. It is expected to rise further in April. India’s CPI inflation has been fluctuating around a high level. As early as October 2020, it had hit a peak of 7.61%. It had remained at a high level of over 6% since April 2020. It did come down after December 2020 but has started rising significantly from January 2022.

On the other hand, the Wholesale Price Index (WPI) inflation had remained in double digits since April 2021. The GDP implicit price deflator-based inflation rate for 2021-22 is 9.6%.

Even though the RBI’s mandate is with respect to CPI inflation, policymakers cannot ignore the behaviour of other price indices. In the 2008-09 crisis, central banks of developed countries, particularly the Fed, had been blamed for overlooking the sharp rise in asset prices, even though CPI inflation was modest.

After the advent of COVID-19, the major concern of policymakers all over the world was to revive demand. This was sought to be achieved by raising government expenditure. This is the standard Keynesian prescription. The severe lockdowns imposed to prevent the spread of COVID-19 restricted the mobility of people, goods and services.

Thus, the expansion in government expenditure did not immediately result in increased production in countries where the lockdown was taken seriously. India belongs to this category. As V.K.R.V. Rao pointed out in the 1950s, the Keynesian multiplier did not work when there were supply constraints as in developing countries. That is why he argued that the multiplier operated in nominal terms rather than in real terms in such countries. Something similar has happened in the present case where the supply constraint came from a non-mobility of factors of production.

Nevertheless, the prescription of enhanced government expenditure is still valid under the present circumstances. Perhaps the increase in output could happen with a lag and also with the relaxation of restrictions. Initially, the focus of monetary policy in India has been to keep the interest rate low and increase the availability of liquidity through various channels, some of which have been newly introduced. However, the growth rate of money was below the growth rate in reserve money. This is because of lower credit growth which also depends on business sentiment and investment climate. Thus the money multiplier is lower than usual. The Government’s borrowing programme which was larger went through smoothly, thanks to abundant liquidity.

Even as the economy picked up steam in 2021-22, inflation also became an issue. As mentioned at the beginning, this is a worldwide phenomenon. In the U.S., the explanation has been quite simple. There has been a balance sheet explosion of the Fed. On January 1, 2020 the total assets (less some items) of the Fed stood at $4.17 trillion and in April 2022, at $8.96 trillion. This massive expansion in assets is the result of quantitative easing which essentially means liquidity support provided by the Fed.

Editorial | Inevitable increase: On RBI's interest rate hike

The Fed Chairman has made strong statements expressing the need to reduce the size of the assets. The Fed is planning to shrink its balance sheet by $95 billion a month. It raised the policy rate by 50 basis points a few days ago. In India too there is a shift in monetary policy. The latest monetary policy reiterates the stance as one of "to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". Without efforts to curtail liquidity, inflation will not come down.

I go back to a point which I have been making several times recently. While discussing inflation, analysts including policymakers focus almost exclusively on the increases in the prices of individual commodities such as crude oil as the primary cause of inflation. The Russian-Ukraine war is cited as a primary cause. True, in many situations including the current one, they may be the triggers. Supply disruptions due to domestic or external factors may explain the behaviour of individual prices but not the general price level which is what inflation is about. Given a budget constraint, there will only be an adjustment of relative prices.

Besides the fact that any cost-push increase in one commodity may get generalised, it is the adjustment that happens at the macro level which becomes critical. A long time ago, Friedman said, "it is true that the upward push in wages produced inflation, not because it was necessarily inflationary but because it happened to be the mechanism which forced an increase in the stock of money". Thus, it is the adjustment in the macro level of liquidity that sustains inflation.

The possible trade-off between inflation and growth has a long history in economic literature. The Phillip's curve has been analysed theoretically and empirically. Tobin called the Phillip's curve a 'cruel dilemma' because it suggested that full employment was not compatible with price stability. The critical question flowing from these discussions on trade-off is whether cost-push factors can by themselves generate inflation. Tobin said at one place that inflation 'is neither demand-pull nor cost-push or rather it is both', even though he did not agree with Friedman's extreme position that there would be no pure cost-push inflation.

Also read | ICICI, BoB, BoI, Central Bank revise lending rates after RBI's repo rate increase

In the current situation, it is sometimes argued that inflation will come down, if some part of the increase in crude prices is absorbed by the government. There may be a case for reducing the duties on petroleum products for the simple reason that one segment of the population should not bear excessive burden. The same consideration applies to food prices. But to think that it is a magic wand through which inflation can be avoided is wrong. If the additional burden borne by the government (through loss of revenue) is not offset by expenditures, the overall deficit will widen. The borrowing programme will increase and additional liquidity support may be required.

Commenting on the increase in repo rate and a rise in CRR, some have commented that this is double whammy. No, these are concomitant decisions. Central banks cannot order interest rates. For a rise in the interest rate to stick, appropriate actions must be taken to contract liquidity. That is what the rise in CRR will do. In the absence of a rise in CRR, liquidity will have to be sucked by open market operations. As the RBI Governor Shaktikanta Das put it in his statement, "Liquidity conditions need to be modulated in line with the policy action and stance to ensure their full and efficient transmission to the rest of the economy."

Inflation in India cannot be described just as ‘cost-push’. Abundance of liquidity has been an important factor. The April Monetary Policy statement talked of a liquidity overhang of the order of 8.5 lakh crore. Beyond a point, inflation itself can hinder growth. Negative real rates of interest on savings are not conducive to growth. If we want to control inflation, action on liquidity is very much needed with a concomitant rise in the interest rate on deposits and loans.

C. Rangarajan is a former Chairman of the Economic Advisory Council to the Prime Minister and a former Governor, Reserve Bank of India

END