Controlling Inflation by acting on Liquidity

Why in news?

Inflation in India cannot be described just as 'cost-push' and an abundance of liquidity can also be an important factor.

What is the trend of inflation in India?

- Inflation is the rate at which the value of a currency is falling and, consequently, the general level of prices for goods and services is rising.
- Consumer price index (CPI) inflation in India stood at 6.95% in March 2022.
- 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%.
- The rural inflation surged to 7.66% in March 2022 and has surpassed the urban inflation by 0.2 percentage points in January 2022.
- With increasing trends in inflation, the RBI has decided to raise the repo rate by 40 basis points and cash reserve ratio (CRR) by 50 basis points.

> *The RBI's mandate is with respect to CPI inflation and it targets inflation at 4% with a tolerance level of two percentage points on either side.*

What is the impact of raising government expenditure on production?

- After the advent of COVID-19, the major concern of policymakers all over the world was to revive demand and this was sought to be achieved by raising government expenditure.
- This is the standard ***Keynesian prescription*** which implies government intervention for increasing aggregate demand when private demand falls.
- The severe lockdowns restricted the mobility of people, goods and services and the expansion in government expenditure did not immediately result in increased production in countries like India.
- This was explained by V.K.R.V. Rao in the 1950s that the Keynesian multiplier did not work when there were supply constraints as in developing countries.
- He argued that the multiplier operated in nominal terms rather than in real terms in such countries.

Is increased government expenditure possible under current scenario?

- The prescription of enhanced government expenditure is still valid but the increase in output could happen with a lag and 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.
- However, the growth rate of money was below the growth rate in reserve money because of lower credit growth.
- Thus the money multiplier is lower than usual and the Government's borrowing programme was larger and it went through smoothly.
- Even as the economy picked up steam in 2021-22, inflation also became an issue.

What is the role of liquidity in controlling inflation?

- Without efforts to curtail liquidity, inflation will not come down.
- Mostly, the policymakers focus on the increase in the prices of individual commodities such as crude oil as the primary cause of inflation.
- That is true in many situations but 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.
- Any cost-push increase in one commodity may get generalised, but it is the adjustment that happens at the macro level which becomes critical.
- It is the adjustment in the macro level of liquidity that sustains inflation.
- The April Monetary Policy statement talked of a liquidity overhang of the order of ₹8.5 lakh crore.

What is the trade-off between inflation and growth?

- The Phillip's curve suggests that full employment was not compatible with price stability.
- The critical question flowing on trade-off is whether cost-push factors can by themselves generate inflation.
- At one place that inflation is neither demand-pull nor cost-push or rather it is both.
- In the current situation, it is argued that inflation will come down, if some part of the increase in crude prices is absorbed by the government.
- 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.

References

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