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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