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Inflation and MPC

Paper-3

Economy

NEWSPAPER PT CUM MAINS

WORK-SHEET-R-5

Part - 1

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Inflation

Inflation refers to the rise in the prices of most goods and services of daily or common use, such as food, clothing, housing, recreation, transport, consumer staples, etc. Inflation measures the average price change in a basket of commodities and services over time. The opposite and rare fall in the price index of this basket of items is called 'deflation'. Inflation is indicative of the decrease in the purchasing power of a unit of a country's currency. This is measured in percentage.

Why?

- **Demand Side inflation is caused by** high demand and low production or supply of multiple commodities create a demand-supply gap, which leads to a hike in prices due to increase in consumption; Also, Increase in exports which undervalues rupee; Also, the excess circulation of money leads to inflation as money loses its purchasing power With people having more money, they also tend to spend more, which causes increased demand.
- **Cost Pull inflation** is caused by shortage of factors of production like labour, land, capital etc. and also due to artificial scarcity created due to hoarding. For example, Brent crude prices crossed $65 per barrel in May 2021, more than double of what it was a year ago. Price of vegetable oils, a major import item, shot up 57% to reach a decadal high in April 2021. Metals prices are near the highest in 10 years and international freight costs are escalating.

Causes of Inflation

Inflation is mainly caused either by demand Pull factors or Cost Push factors. Apart from demand and supply factors, Inflation sometimes is also caused by structural bottlenecks and policies of the government and the central banks. Therefore, the major causes of Inflation are:

- Demand Pull Factors (when Aggregate Demand exceeds Aggregate Supply at Full employment level).
- Cost Push Factors (when Aggregate supply increases due to increase in the cost of production while Aggregate demand remains the same).
- Structural Bottlenecks (Agriculture Prices fluctuations, Weak Infrastructure etc.)
- Monetary Policy Intervention by the Central Banks.

- Expansionary Fiscal Policy by the Government.

Demand Pull Inflation

- Demand Pull Inflation is mainly due to increase in Aggregate demand. The increase in Aggregate demand mainly comes from either increase in Government Expenditure (Expansionary Fiscal Policy) or by an increase in expenditure from Households and Firms.
- The root cause of demand pull inflations is- Aggregate demand > Aggregate Supply. This simply means that the firms in the economy are not capable of producing the goods and services demanded by the households in the present time period. The shortages of goods and services due to increase in demand fuels inflation.
- Imagine what happened when there was an outbreak of swine flu in India. Due to the outbreak of swine flu epidemic in India, the government notified a warning that people should wear Breathing Masks to protect them from the infection. As a result, the demand for mask had risen to a very high level, but the supply being limited as the producers of the mask had no anticipation of the swine flu epidemic. Due to the high demand and limited supply of masks, the prices had risen manifold. The case above captures the mechanism of demand pull inflation.

- The above example only captures the mechanism of Demand led inflation and that too for a particular product. What happens at Macro level? What fuels inflation in the entire economy? Before answering the question. Let's understand some basic concept related to the economy:
- **Full Employment Level:** Full employment is an economic situation in which all the available resources of the economy are fully utilised, and there exists no further scope of improvement in the economy. The Full employment level represents that economy is operating at its maximum potential. The level of unemployment is minimum, the prices in the economy are stable, resources are fully utilised, whatever firms are producing is getting sold, and there exist no shortages in the economy.

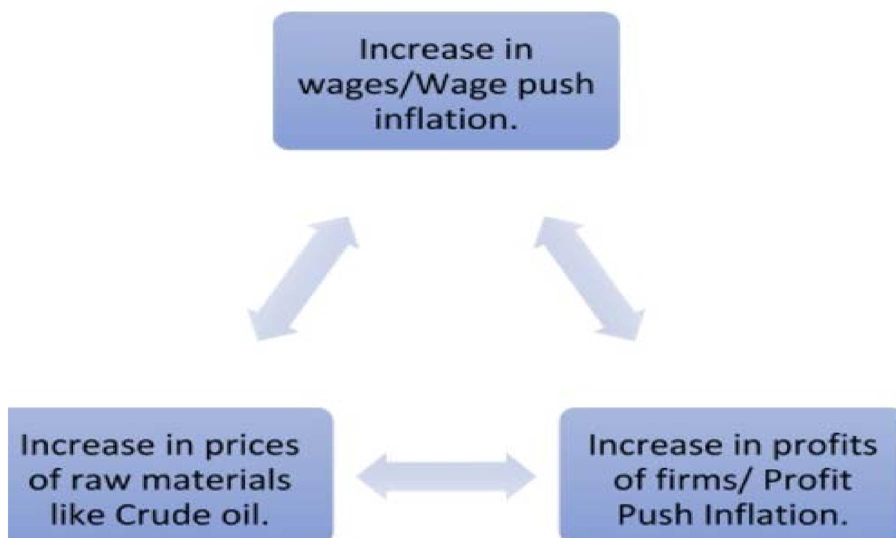
Inflationary Gap: the Inflationary gap is a situation which arises when Aggregate demand in an economy exceeds the Aggregate supply at the full employment level.

Inflation in a Demand-Pull scenario is basically caused by a situation whereby the Aggregate demand for goods and services in the economy rises and exceeds the available supply of the goods and services. In such a situation, the excessive pressure on demand will fuel the inflation in the economy.

Deflationary Gap: Deflationary Gap is a situation which arises when Aggregate demand in the economy falls short of Aggregate Supply at the full employment level.

Cost Push Inflation

- There exists a situation in an economy where inflation is fuelled up, not because of increase in Aggregate Demand but mainly due to increase in the cost of producing goods and services.



Wage Push Inflation	Profit Push Inflation	Raw Material Push Inflation
When the employees push for an increase in wages which are not justifiable either on the grounds of employee productivity or increase in the cost of living. In such scenarios, an unwarranted wage increase leads to increase in the cost of production and hence cost push inflation.	The firms sometimes decide to increase their profit margins and starts charging higher prices for their product. This phenomenon pushes the price upward and results in Profit Push Inflation.	The raw material push inflation also known as supply shock inflation is the main and the most important reason for cost push inflation. If for any reason the economy under goes a supply shock in the form of a rise in the price of essential raw materials like crude oil, it will fuel inflation due to rise in the cost of production.
Wage Push Inflation generally happens during high growth periods. During which workers anticipate a hike in their wages due to rising cost of living. The employer responds to their demand by increasing wages in the hope that he will pass them on to the consumers in the form of higher prices.	The Profit Push Inflation generally happens when there are few of single producer producing the goods for the entire market.	For Example, during the 1970s, the OPEC countries decided to increase the price of crude oil, this acted as a supply shock for the entire World economy and price of petroleum products (an essential raw material) went up, fuelling inflation.

Stagflation: The most important difference between the Demand Pull and Cost Push Inflation is that while in the case of Demand Pull Inflation the overall output in the economy does not fall. Whereas, in case of Cost Push Inflation, along with an increase in prices the output level of the economy also falls.

The fall in output will cause employment to fall in the economy along with fall in growth. The falling growth along with rising prices makes cost push inflation more

dangerous than the demand-pull inflation. The situation of rising prices along with falling growth and employment is called as stagflation.

Hyperinflation: Hyperinflation is a situation when inflation rises at an extremely faster rate. The rate of inflation can increase from 50 times to 300 times.

The effects of hyperinflation can be devastating for the economy. The situation can lead to total collapse of the value of the currency of the economy along with economic crisis and rising external debt and fall in purchasing power of money.

The major causes of the hyperinflation are; government issuing too much currency to finance its deficits; wars and political instabilities and unexpected increase in people's anticipation of future inflation.

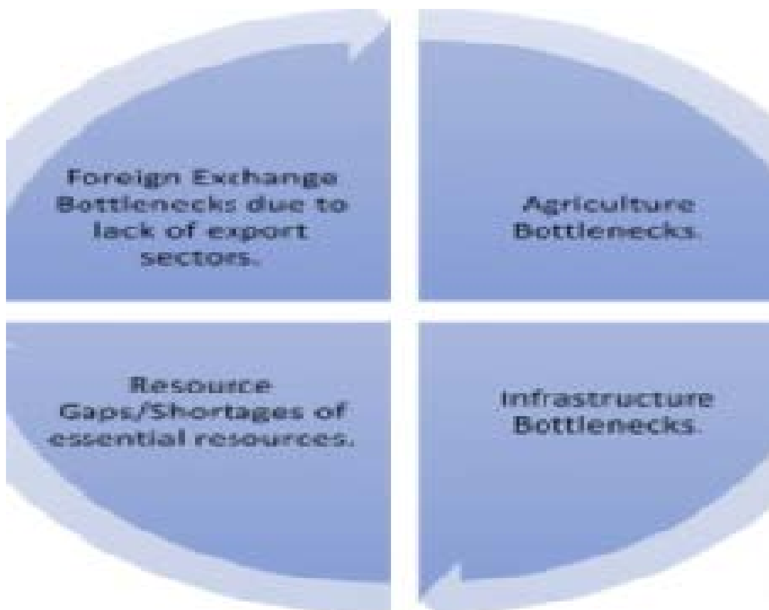
When people anticipate that future inflation will rise at a very fast pace, they start consuming more goods and services due to the fear that higher inflation in the future will destroy the purchasing power of money. As a result of this, the demand for goods and services rises and fuels further inflation. The cycle continues and results in a hyperinflation scenario.

Structural Inflation

- Structuralist Inflation is another form of Inflation mostly prevalent in the Developing and Low-Income Countries.
- The Structural school argues that inflation in the developing countries are mainly due to the weak structure of their economies.
- They further argue that increase in money supply and government expenditure could explain the inflationary scenario only partially.
- The Structuralist argues that the economies of developing countries like, Latin America and India are structurally underdeveloped as well as highly volatile due to the existence of weak institutions and imperfect working of markets.
- As a result of these imperfections, some sectors of the economy like agriculture will witness shortages of supply, whereas some sectors like consumer goods will witness excessive demand. Such economies face the problem of both shortages of supply, under utilisation of resources as well as excessive demand in some sectors.
- Example: In India, let's assume that the farmer produces fruits and vegetables at 10000 per quintal. But the final consumer gets the same at 20000 per quintal. The huge disparity between what farmer receives and consumer pays is due to infrastructure and agriculture bottlenecks. The bottleneck arises

mainly due to lack of roads, highways, cold chains and underdeveloped agriculture markets. All these increases the cost of transporting goods from farmers to consumers leading to inflation.

- The major bottlenecks/road blocks of developing economies that fuels Structuralist form of inflation are:



Deflation: Deflation is when the overall price level in the economy falls for a period of time.

Disinflation: Disinflation is a situation in which the rate of inflation falls over a period of time. Remember the difference; disinflation is when the inflation rate is falling from say 5% to 3%.

Deflation is when, for instance, the price of a basket of goods has fallen from Rs 100 to Rs 80. It's the reduction in overall prices of goods.

Reaganomics

Reaganomics is a popular term used to refer to the economic policies of Ronald Reagan, the 40th U.S. president (1981–1989), which called for widespread tax cuts, decreased social spending, increased military spending and the deregulation of domestic markets. These economic policies were introduced in response to a prolonged period of economic stagflation that began under President Gerald Ford in 1976.

Headline versus Core Inflation

The headline inflation measure demonstrates overall inflation in the economy. Conversely, the core inflation measures exclude the prices of highly volatile food and fuel components from the inflation index.

The inflation process in India is dominated to a great extent by supply shocks. The supply shocks (e.g., rainfall, oil price shocks, etc.) are temporary in nature and hence produce only temporary movements in relative prices. The headline CPI inflation in India tends to increase whenever there is a surge in food and fuel prices. Since monetary policy is a tool to manage aggregate demand pressures, the response of the policy to such temporary shocks is least warranted according to traditional wisdom.

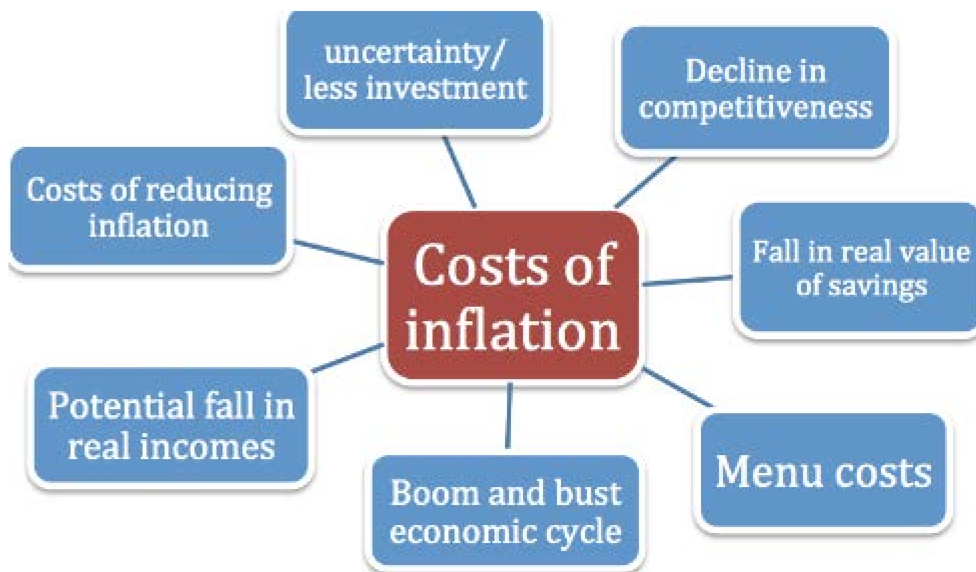
Core inflation excludes the highly volatile food and fuel components and therefore represents the underlying trend inflation. The trend inflation drives the future path of overall inflation. Hence, even when food and fuel inflation moderates over time, persistently high inflation in non-food, non-fuel components pose an upward risk to overall future inflation, creating challenges to monetary policy.

Causes of Inflation:		
	Factors affecting Demand:	1. Increase in Money Supply:
		2. Increase in Disposable Income:
		3. Increase in Public Expenditure:
		4. Increase in Consumer Spending:
		5. Cheap Monetary Policy:
		6. Deficit Financing:
		7. Expansion of the Private Sector:
		8. Increase in Population:
		9. Black Money:
		10. Repayment of Public Debt:
		11. Increase in Exports:
	Factors affecting Supply:	1. Shortage of Factors of Production:
		2. Industrial Disputes:
		3. Natural Calamities:
		4. Artificial Scarcities:
		5. Increase in Exports:
		6. Lop-sided Production:
		7. Law of Diminishing Returns:
		8. International Factors:
		9. Increase in Cost of Production:

Is Inflation bad for everyone?

A too high or a too low inflation is harmful to the economy. However, a moderate value is actually good for the economy.

In general, Inflation is perceived differently by everyone depending upon the kind of assets they possess. For someone with investments in real estate or stocked commodity, inflation means that the prices of their assets are set for a hike. For those who possess cash, they may be adversely affected by inflation as the value of their cash erodes.



Who gains, who loses

Gainers

- Businessmen gains as the prices of their products go up and so does their profits.
- Farmer's cost of production will not go up drastically in the short run and thus will ain.
- Shareholders will get better returns as businesses will be making more profits.
- Governments that are in debt will also find their burden reduced.
- Debtors will gain as the real value of money has gone down since the time they took the loan.

Losers

- Creditors lose as the principle sum received is less in terms of real income.
- Wage earners will find their real wages going down and thus lose.
- Pensioners usually have a fixed income and will lose.
- Students, unemployed people will lose.
- Bondholders, those who have purchases bonds from government and companies will lose.

Inflation

Advantages

- Moderate inflation enables economic growth
- Moderate inflation allows adjustment of real wages
- Moderate inflation allows adjustment of prices.
- Inflation is better than deflation – which can cause recession.

Disadvantages

- Creates uncertainty and lower investment
- High inflation often leads to lower growth and less stability
- Reduces international competitiveness
- To reduce inflation can lead to recession
- Fall in value of savings
- If wages don't keep up – lower real wages.

Why is moderate rate of inflation good for an economy?

This acts as a stimulant for the economy by providing it with some momentum.

When we start expecting sustained price rise, we increase our spendings in order to beat inflation and as such this stimulates the growth of the economy. As we start spending more, it would increase the profit of the businesses who then start hiring more people or raise the salary of the existing employees or expand. All these, in turn, will help in the growth of the economy. Thus, this acts as an incentive for consumers to spend more, businesses to invest, wages to rise and employment to expand thereby helping the economy to grow.

Inflation Target

- Inflation is measured by a central government authority, which is in charge of adopting measures to ensure the smooth running of the economy. In India, the Ministry of Statistics and Programme Implementation measures inflation.
- RBI through its Monitory Policy Committee Controls Inflation with its tools to control Money supply in the market.
- The Central Government has notified 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016, to March 31, 2021, with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

Urijit Patel Committee was set up by the former governor of the Reserve Bank of India (RBI), Raghuram Rajan in 2016. The committee was primarily responsible for revising and strengthening the Monetary Policy Framework introduced by the RBI. Some key suggestions made by the committee include the following:

- Control Inflation
- Control Consumer Price Index (CPI)
- Accountability of decision-making shall fall upon a majority and not an individual
- Define a target for better implementation of decisions

Recommendations – Urjit Patel Committee

- Use CPI as a mean to measure inflation of the country not WPI – (Food + Fuel)
- **Target** 4% CPI, +/-2% Band [control inflation in 2-6% range.]
- **Tool** Repo as policy rate, +/-1% spread in R-Repo & MSF,
- **Time limit** 0/12/24 (months) = 10/8/6% (CPI)

Strategy

keep Repo rate higher than CPI

RBI to fix accountability in monetary policy making – Form a Monetary committee of 5 members

- Governor
- Governor
- RBI's Executive Director
- Two outsiders/External members

Noted Economists, finance experts etc., who're not office bearers in RBI.

Term: three years + Not eligible for re-appointment

MPC Must issue a public statement & every MPC member must sign it

This statement will contain :

- Why did we fail? (Reasons)
- How will we fix it (Future action proposed)
- By when will we fix it? (Timeframe)
- Government to help RBI to achieve set targets
- Eliminate administered prices (MSP on food grains, LPG cylinders)
- Eliminate administered wages (MNREGA)
- Eliminate administered interest rates (interest subvention given to farmers)
- Implement Vijay Kelkar Committee's recommendations on fiscal consolidation.
- Religiously follow the guidelines & targets of FRBM

Present Targets	
2015 Jan	CPI Target (8%)
2016 Jan	CPI Target (6%)
2017 Jan	CPI Target (4%)

Union Government and RBI signed an agreement on Monetary Policy Framework → Finance Minister to set inflation targets for RBI

- will specify the inflation targets for RBI, contrary to the recommendation of Urjit Patel Committee

- Until now, the RBI has the sole power to regulate the monetary policy & set inflation targets

Presently, Union Government and RBI give inflation estimates and do not set targets. But as per this agreement government has set a target for RBI to bring down inflation –

- below 6 % by January 2016
- 4 percent +/-2 percentage points for 2016-2017 & all subsequent years

This agreement mentions that if RBI fails to meet the target, it will –

- Report to the government with the reasons for the failure to achieve the target
- Propose remedial actions to be taken.
- Further estimate the time period within which the failed target would be achieved.

As per the agreement, this Monetary Policy Framework will be monitored by the RBI and it is binding on Union Government to take proactive measures for price control.

Tools to measure inflation → WPI, CPI, GDP DEFLATOR

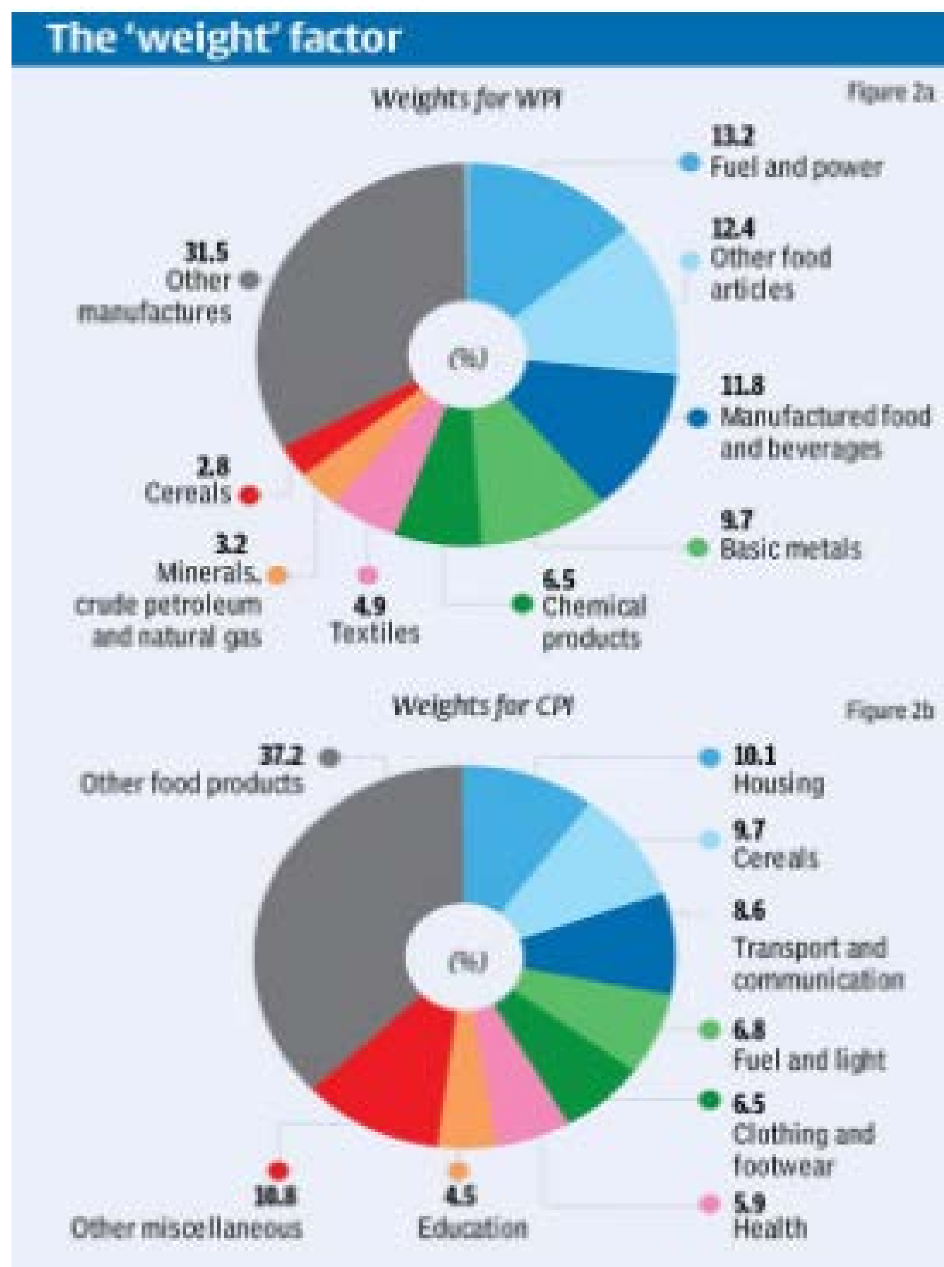
- Before April 1, 2014 inflation was measured on WPI – (Food + Fuel)
- From April 1, 2014 will be measured on CPI based on Urjit patel committee recommendations.

WPI – Wholesale price index

- Also known as Headline inflation → Calculated Weekly
- Compiled by Office of Economic Adviser (Under Ministry of Commerce and Industry) on base year 2012
- Measures inflation at wholesale level (Average of all goods bought by traders) consisting approx. 676 items
- Does not cover services

CPI – Consumer price index

- Used by RBI to formulate Monitory Policies → Calculated Monthly
- Compiled by CSO under statistics Ministry on Base year 2012
- Measures inflation at final level or retail level (Average of all goods bought by consumers) consisting approx. 200 items.
- Do cover services



CPI Before 2011	CPI After 2011
There were 4 subtypes of CPI ▪ Agricultural Labour ▪ Rural Labour ▪ Industrial Worker	Now only 3 subtypes of CPI ▪ Entire Urban population ▪ Entire Rural population ▪ Urban + Rural (Consolidated

▪ Urban Non Manual Employees	from above two)
▪ First 3 subtypes of CPI were calculated by Labour Bureau → Ministry of Labour & Employment ▪ Last subtype was prepared by Central Statistical Organization (CSO) → Ministry of Statistics & Programme implementation	▪ All prepared by Central Statistical Organization (CSO) → Ministry of Statistics & Programme implementation
Different base years for different subtypes ▪ Agricultural Labour → 1986 ▪ Rural Labour → 1986 ▪ Industrial Worker → 2001 ▪ Urban Non Manual Employees → 1984	▪ Common base year (2012) for all three subtypes

GDP Deflator

- Compiled by CSO under statistics Ministry → Calculated Quarterly

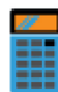
The GDP deflator, also called implicit price deflator, is a measure of inflation. It is the ratio of the value of goods and services an economy produces in a particular year at current prices to that of prices that prevailed during the base year.

This ratio helps show the extent to which the increase in GDP has happened on account of just rise in prices rather than increase in output. Since the deflator covers the entire range of goods and services produced in the economy — as against the limited commodity baskets for the wholesale or consumer price indices — it is seen as a more comprehensive measure of inflation.

Nominal Versus Real GDP

Nominal GDP
- GDP measured in terms of the price level at the time of measurement (NOT adjusted for inflation).

Real GDP
- GDP adjusted for inflation.
- Nominal GDP is *deflated* (if prices increased) or *inflated* (if prices fell).
- Only real GDP measures changes in output accurately, holding price constant.



$$\text{GDP Deflator Formula} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

MPC and controlling factors of INFLATION

Monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the Act.

The primary objective of the RBI's monetary policy is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition to sustainable growth.

The amended **RBI Act, 1934** also provides for the **inflation target (4% +-2%)** to be set by the Government of India, in consultation with the Reserve Bank, once in every five years.

Various Instruments of Monetary Policy	
Repo Rate:	▪ The interest rate at which the Reserve Bank **provides overnight liquidity** to banks **against the collateral of government and other approved securities** under the **liquidity adjustment facility (LAF).** ▪ **Liquidity Adjustment Facility (LAF)** is a tool used in monetary policy by the RBI, that allows banks to borrow money through repurchase agreements (repos) or for banks to make loans to the RBI through reverse repo agreements.
Reverse Repo Rate:	▪ The interest rate at which the **Reserve Bank absorbs liquidity** on an overnight basis, from

	banks against the **collateral of eligible government securities under the LAF.**
Liquidity Adjustment Facility (LAF):	▪ The LAF **consists of overnight as well as term repo auctions.** ▪ The aim of term repo is to help develop the **interbank term money market,** which in turn can set market based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. ▪ The RBI also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.
Marginal Standing Facility (MSF):	▪ A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory **Liquidity Ratio (SLR)** portfolio up to a limit at a penal rate of interest. ▪ This provides a safety valve against unanticipated liquidity shocks to the banking system.
Corridor:	▪ The MSF rate and reverse repo rate determine the **corridor for the daily movement in the weighted average call money rate.**
Bank Rate:	▪ It is the rate at which the RBI is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under **Section 49 of the RBI Act, 1934.** ▪ This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Cash Reserve Ratio (CRR):	▪ The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its **Net demand and time liabilities (NDTL)** that the Reserve Bank may notify from time to time in the **Gazette of India.**
Statutory Liquidity Ratio (SLR):	▪ The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, **unencumbered government securities, cash and gold.** ▪ Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
Open Market Operations (OMOs):	▪ These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.
Market Stabilisation Scheme (MSS):	▪ This instrument for monetary management **was introduced in 2004.** ▪ Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. ▪ The cash so mobilised is **held in a separate government account with the RBI.**

What is the Monetary Policy Committee (MPC)?

- **Origin:** Under **Section 45ZB of the amended (in 2016) RBI Act, 1934,** the central government is empowered to constitute a six-member Monetary Policy Committee (MPC).
- **Objective:** Further, Section 45ZB lays down that "the **Monetary Policy Committee** shall determine the Policy Rate **required to achieve the**

inflation target".
  - The decision of the Monetary Policy Committee shall be binding on the Bank.
- **Composition:** Section 45ZB says the MPC shall consist of **6 members:**
  - **RBI Governor** as its **ex officio chairperson,**
  - Deputy Governor in charge of monetary policy,
  - An officer of the Bank to be nominated by the Central Board,
  - **Three persons** to be **appointed by the central government.**
    - This category of appointments must be from "persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy".

PYQ

Which of the following statements is/are correct regarding the Monetary Policy Committee (MPC)? (2017)

1. It decides the RBI's benchmark interest rates.
2. It is a 12-member body including the Governor of RBI and is reconstituted every year.
3. It functions under the chairmanship of the Union Finance Minister.

Select the correct answer using the code given below:
(a) 1 only
(b) 1 and 2 only
(c) 3 only
(d) 2 and 3 only
Ans: (a)

With reference to Indian economy, consider the following: (2015)

1. ***Bank rate***
2. ***Open market operations***
3. ***Public debt***
4. ***Public revenue***

Which of the above is/are component/ components of Monetary Policy?
(a) 1 only
(b) 2, 3 and 4
(c) 1 and 2
(d) 1, 3 and 4

Ans: (c)

What is Monetary Policy Framework?

- **Origin:** In May 2016, the RBI Act was amended to provide a legislative mandate to the central bank to operate the country's monetary policy framework.
- **Objective:** The framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation, and modulation of liquidity conditions to anchor money market rates at or around the repo rate.
- **Reason for Repo Rate as Policy Rate:** Repo rate changes transmit through the money market to the entire financial system, which, in turn, influences aggregate demand.
  - Thus, it is a key determinant of inflation and growth

Various Policy Stances of RBI	
Accommodative:	▪ An accommodative stance means **the central bank is prepared to expand the money supply to boost economic growth.** ▪ The central bank, during an accommodative policy period, is willing to cut the interest rates. A rate hike is ruled out. ▪ The central bank typically **adopts an accommodative policy when growth needs policy support and inflation is not the immediate concern.**
Neutral:	▪ A 'neutral stance' suggests that the central bank can **either cut rate or increase rate.** ▪ This stance is typically **adopted when the policy priority is equal on both inflation and growth.** ▪ The guidance indicates that the market can

	expect a rate action on either way at any point.
Hawkish Stance	▪ A hawkish stance **indicates that the central bank's top priority is to keep the inflation low.** ▪ During such a phase, the **central bank is willing to hike interest rates to curb money supply and thus reduce the demand.** ▪ A hawkish policy also indicates tight monetary policy. ▪ When the central bank increases rates or 'tightens' the monetary policy, banks too increase their rate of interest on loans to end borrowers which, in turn, curbs demand in the financial system.
Calibrated Tightening:	▪ Calibrated tightening means **during the current rate cycle, a cut in the repo rate is off the table.** ▪ However, the **rate hike will happen in a calibrated manner.** ▪ This means the central bank may not go for a rate increase in every policy meeting but the overall policy stance is tilted towards a rate hike. ▪ This can happen outside the policy meetings as well if the situation warrants.

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimise the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:
(a) 1 and 2 only
(b) 2 only
(c) 1 and 3 only
(d) 1, 2 and 3
Ans: (b)

Q. The lowering of Bank Rate by the Reserve Bank of India leads to (2011)
(A) More liquidity in the market
(B) Less liquidity in the market
(C) No change in the liquidity in the market
(D) Mobilization of more deposits by commercial banks
Ans: A

Q. Consider the following statements: (2020)

1. ***The weightage of food in Consumer Price Index (CPI) is higher than that in Wholesale Price Index (WPI).***
2. ***The WPI does not capture changes in the prices of services, which CPI does.***
3. ***Reserve Bank of India has now adopted WPI as its key measure of inflation and to decide on changing the key policy rates.***

Which of the statements given above is/are correct?
(A) 1 and 2 only
(B) 2 only
(C) 3 only
(D) 1, 2 and 3
Ans: A

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)
1. Cut and optimize the Statutory Liquidity Ratio

2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate
Select the correct answer using the code given below:
(A) 1 and 2 only
(B) 2 only
(C) 1 and 3 only
(D) 1, 2 and 3
Ans: B

Main Methods to control inflation

- **Monitory Policy :** Monetary policy is one of the most commonly used measures taken by the government to control inflation. It uses tools like – Bank rate, Repo Rate, Open market operations, etc.
- **Fiscal Policy :** The two main components of fiscal policy are government revenue and government expenditure. In fiscal policy, the government controls inflation either by reducing private spending or by decreasing government expenditure, or by using both. It reduces private spending by increasing taxes on private businesses. When private spending is more, the government reduces its expenditure to control inflation. However, in present scenario, reducing government expenditure is not possible because there may be certain on-going projects for social welfare that cannot be postponed.
- **Price Control :** In this method, inflation is suppressed by price control, but cannot be controlled for the long term. The historical evidences have shown that price control alone cannot control inflation, but only reduces the extent of inflation.

RECENT CURRENT NEWS

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 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 the coming months.

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%.

In this context, it is imperative to understand the issue of inflation and measures that need to be taken in order to contain inflation.

What are the Reasons for Increasing Inflation in India Lately?

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.

The **high rate of inflation** in March 2022 is primarily due to rise in prices of crude petroleum and natural gas, mineral oils, basic metals, etc. owing to disruption in the global supply chain caused by the Russia-Ukraine conflict.

On the other hand, the retail inflation rose mainly on account of rising prices of essential food items like **'oils and fats', vegetables and protein-rich items such as 'meat and fish'**.

As per the CPI data, inflation in 'oils and fats' in March soared to 18.79% as the geopolitical crisis due to the Russia-Ukraine war pushed edible oil prices higher. Ukraine is a major exporter of sunflower oil. In vegetables, inflation quickened to 11.64% in March, while in 'meat and fish' the rate of price rise stood at 9.63 compared to February 2022.

- The sharp rise in commodity prices across the world is a major reason behind the inflation spike in India. This is increasing the import cost for some of the crucial consumables, pushing inflation higher.

Impact of Higher Inflation in India?

- **Repo Rate:**

- It is expected to push up interest rates in the banking system. Equated Monthly Installments (EMIs) on home, vehicle and other personal and corporate loans are likely to go up.
- Deposit rates, mainly fixed term rates, are also set to rise.
- Consumption and demand can be impacted by the Repo rate hike.

- **CRR:**
  - The hike in CRR will suck out Rs 87,000 crore from the banking system. The lendable resources of banks will come down accordingly.
  - It also means the cost of funds will go up and banks' net interest margins could get adversely impacted.
  - Net interest margin (NIM) is a measure of the difference between the interest income earned by a bank or other financial institution and the interest it pays out to its lenders (for example, depositors), relative to the amount of their assets that earn interest.

What are the Challenges in Tackling Increasing Inflation?

- 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. 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.
- 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 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."

What can be done to contain inflation?

- **Fuel duty cut:**
  - Further duty cuts by some amount at least Rs 5 per litre according to expers.
  - It can likely lower the inflation by 15-20 bps.
  - It Has immediate and secondary impact on electricity, transport cost
  - 1% rise in oil (Indian basket) could raise WPI by 8 bps.
- **Food Prices:**
  - Crackdown on supply side if hoarding happens
  - Ease import limits on pulses, oil seed
- **More duty cuts:**
  - More duty cuts for edible oil imports is required. However, it was reduced from 19 .25%to 13.75%.
- **Buffer stock:**
  - Prepare to use buffer stock if inflation spills over to cereals
  - 1% rise in WPI primary food prices can go up CPI by 48 bps
- **Other measures:**
  - Press for faster growth: 10% higher industrial output can ease retail inflation by 40 bps
  - Address supply bottlenecks
  - Boost income generating capacity to reduce burden on low income households

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All the best
JAI HIND

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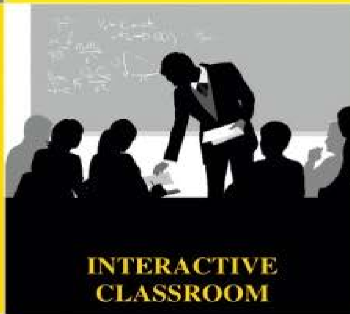

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