Mains Marathon

Day 36: Inflation in India cannot be described just as ‘cost-push’. Abundance of liquidity has been an important factor. Discuss. (150 Words)

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Approach / Explaination / Answer

- Start your answer by defining inflation.
- Explain the reasons for Inflation in India especially in two headings – ‘Cost push inflation’ and inflation due to abundance of liquidity.
- Briefly give measures to contain current Inflation.

Answer:

Inflation is a **rise in prices,** which can be translated as **the decline of purchasing power over time**. Inflation in India has been above 6% since the start of 2022 (before Russia’s invasion of Ukraine happened in February. Inflation in India cannot be described just **as ‘cost-push’. Abundance of liquidity** has been an important factor. **Cost-push inflation** means prices have been "pushed up" by increases in the costs of any of the four factors of production — **labor, capital, land, or entrepreneurship**. Liquidity is the cash or money in a system. Liquidity is measured in terms of the monetary base and the Reserve Bank of India (RBI) is the sole supplier of liquidity in the country.

Reasons for Increasing Inflation in India Lately

- **Cost push inflation:**
    - **Disruptions due to global supply chain:** The high rate of inflation in 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.
        - 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.
    - **Increasing the import cost:** 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.
    - **Cascading effect:** When prices of oil and fertilizer increase, there is bound to be a cascading effect on all other prices — which eventually the customer has to pay for.
- **Abundance of liquidity:**
    - The **excessive liquidity parked by central banks** and the spending done by various

governments **to curb the effects of the pandemic**. This was about $9 trillion and slowly it was **excessive money chasing too few goods** thus stoking inflation. Probably the urge to recover from the lows of the pandemic impelled the global economies to go overboard on monetary and fiscal support. The result was runaway inflation in most global economies.
    - Excessive liquidity has callused runaway inflation in India as the rate is above 4% for over 35 months and above the tolerance limit of 6% for 6 out of the last 12 months.
    - **Failure of Keynesian multiplier theory:** 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.

Measures that can be taken to contain Present inflation

- **Monetary Policy:** The Reserve Bank of India (RBI) is mandated to keep inflation at 4 per cent, plus minus 2 per cent. The RBI has already started the process of **tightening monetary policy** by **raising the repo rate**.
- **Fuel duty cut:** Further duty cuts by some amount at least Rs 5 per liter according to experts. It can likely lower inflation by 15-20 bps. It has immediate and secondary impact on electricity and 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 and oil seed.
- **More duty cuts:** More duty cuts for edible oil imports are 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.

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.