Containing Rising Inflation

This editorial is based on “Control inflation by acting on liquidity” which was published in The Hindu on 12/05/2022. It talks about the issue of rising inflation and measures that can be taken to contain the inflation.

For Prelims: Reserve Bank of India, Repo rate (RR), cash reserve ratio (CRR), Consumer price index (CPI), Wholesale Price Index (WPI),

For Mains: Issues of inflation and measures needed to contain it, relation between inflation and growth

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.

What is Repo rate & CRR?

Repo rate is the interest charged by the RBI when commercial banks borrow from them by selling their securities to the central bank. Essentially it is the interest charged by the RBI when banks borrow from them - much like commercial banks charge you interest for a car loan or home loan.

Under **Cash Reserve Ratio (CRR)**, the commercial banks have to hold a certain minimum amount of deposit as reserves with the central bank. The percentage of cash required to be kept in reserves as against the bank's total deposits is called the Cash Reserve Ratio.

What is the 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

Drishti Mains Question

“The recent action of the Reserve Bank of India (RBI) to raise the repo rate and cash reserve ratio (CRR) is a recognition of the serious situation with respect to inflation in our country. “ Discuss the reasons and suggest some measures to deal with the issue.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

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

- Expansionary monetary policy, or easy monetary policy, is when a central bank uses its tools to stimulate the economy. It increases the money supply, lowers interest rates and increases demand. It boosts economic growth.
- Raising SLR makes banks park more money in government securities and reduce the level of cash in the economy. Doing the opposite helps maintain cash flow in the economy. Hence, statement 1 is not correct.
- With the increase of MSF Rate, cost of borrowing increases for banks resulting in reduced available resources to lend. Hence, statement 2 is correct.
    - Under expansionary monetary policy, RBI reduces repo rate and bank rate to increase liquidity in the banking sector. Hence, statement 3 is not correct.
    - Therefore, option (b) is the correct answer.

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