A more explicit analysis of the impact of monetary policy on inflation is needed

Look for an Inflatable Model

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With consumer price index (CPI) inflation touching 6.9%, there is some concern about where inflation is headed. But somehow these discussions are more focused on causes behind sectoral price increases, such as food price, than the reason for the increase in the general price level. The clear distinction between the two is being overlooked.

With a cap on monetary income, any increase in the price of one commodity will be offset by the decline in the price of other commodities. For general price level to increase, we need to look beyond individual price formations.

Economist Milton Friedman had famously stated, 'Inflation is always and everywhere a monetary phenomenon.' Much water has flown under the bridge since he said that in 1970. We have moved away from the days of his strict 'Quantity Theory of Money', which postulated an increase in prices proportional to the increase in money supply.

There are many modifications and adjustments to the theory. The focus of policymakers has also shifted from quantity to price (read: interest rate). But the fact remains that inflation — defined as a continuous increase in the general price level — can't happen without the intervention of a macro variable, such as money or liquidity. Only relative price changes can be explained by changes in supply and demand relative to individual products.

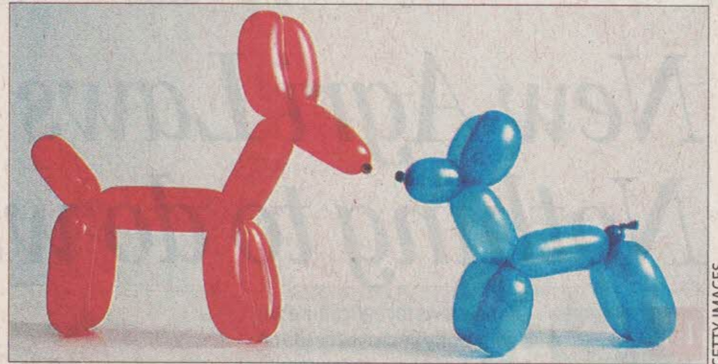
However, the 'Structuralist School' treats inflation as a purely real phenomenon. According to this school, inflation is the result of different segments of society competing with one another to have a larger share of the cake. A modification of this thought is that inflation happens only when society is operating at the limit of its capacity and trying to move beyond. This is popularly described as 'overheating'. These are, however, not sustainable situations. There is a limit to velocity changes.

In the monetary policy statements, the discussions on inflation are mostly centred around real factors. There is also a lot of mention about inflation expectations. But there is no explicit discussion on how their own decisions on policy rate change (and, by implication change, in liquidity) will affect the behaviour of prices. Perhaps the models they use for forecasting growth and other parameters incorporate this factor.

Free Flow of Liquidity

Policy rate changes do have a liquidity impact. Central banks cannot act like King Canute. They can't order interest rates. They have to act on money supply, or the currently preferred term, liquidity. Lowering of policy rate must be accompanied by an enlargement of liquidity. In fact, post-2008, developed economies moved directly to 'quantitative easing', when policy rate changes did not have the desired effect.

In the minutes of the Monetary Policy Committee meeting held on May 20-22, RBI deputy governor Michael Patra rightly observes, 'Relative prices tend to adjust within the budget constraint. For setting monetary policy, however, it is the absolute level of prices and its prospective moments that matter. This warrants a careful assessment of aggregate demand.' He then goes on to talk about the behaviour of money supply. Aggregate demand here must be read as aggregate monetary demand.



Policy inflates

There is a need to clarify one point here. The injection of liquidity is not identical with increase in money supply. The money multiplier depends upon how active banks are in terms of lending. Post-2008, the injection of liquidity by the central banks in developed countries had no impact on general price level because of poor lending. Much of the increase in liquidity ended up as excess reserves, with very little impact on money supply.

Liquidity increase has a dual effect. Availability of credit will push, on the one hand, output and, on the other, demand. Studies show that the demand effect is usually stronger than the output effect.

Given the serious adverse impact of Covid-19, RBI is focused on augmenting liquidity through several channels: open market operations (OMOs), long-term repos (LTRs) and reduction of cash reserve ratio (CRR). At some point, RBI may also have to support the government borrowing programme, which is bound to increase. Thus, liquidity will increase substantially.

The impact on money supply can be significant given the pressure on banks put by policymakers to lend. In that situation, can inflation remain quiet? Thus, the reason for the price increase will be not supply — demand imbalances in relation to individual products — but the overall increase in money supply. The price increase can come with a lag. But given the forecast of a decline in output (GDP), increase in money supply can only push prices forward.

No More Surprices

Policymakers can legitimately take a view that a higher level of inflation can be accepted in a difficult year like this one. If despite strong injection of liquidity, money supply does not increase, or increases modestly, there will be negligible effect on prices. If money supply does increase because of active lending, there will be an impact on prices, particularly if the assumption of negative growth holds. In that case, inflation is policy induced.

It is not 'stagflation'. The purpose of this article isn't to argue against the current stance of monetary policy. It is only to point out that the actions of monetary policy authorities themselves have an impact on inflation. In monetary policy statements, a more explicit analysis of the possible impact of changes in reserve money and money supply on general price level is needed.

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