It would be naïve to wish away the inflationary impact of reserve money expansion

Sure, Have Your Cake, But...

C Rangarajan & DK Srivastava

Both monetary and fiscal policies face serious dilemmas. They need to be understood and resolved if we have to move ahead. There is now consensus on the need to increase government expenditure to revive the economy. Real growth in 2021-22 will have to be 7.8% to make up for the contraction of the economy by 7.3% in 2020-21. Perhaps, a growth rate of at least 9.0% is desirable.

For growth to pick up, the first condition is to lift the lockdown(s) as early as possible. Without it, even increased government expenditures will not work. Overall, government expenditures will have to be at least ₹1.5 lakh crore more than the budgeted expenditures of ₹34.8 lakh crore in 2021-22.

There are clearly added expenditures on vaccination, cash distribution, etc. In this context, fiscal deficit will have to go up. There are also some doubts about revenue assumptions. Perhaps, the fiscal deficit may touch 7.8% of GDP. Fiscal deficit is simply borrowing. Our own estimate is that the total borrowing of GoI may touch ₹16.3 lakh crore, including GST compensation borrowing. It may be noted that in the pre-Covid year of 2019-20, the borrowing programme of the Centre was ₹7.1 lakh crore. Besides GoI's borrowing, there is also the borrowing of the state governments.

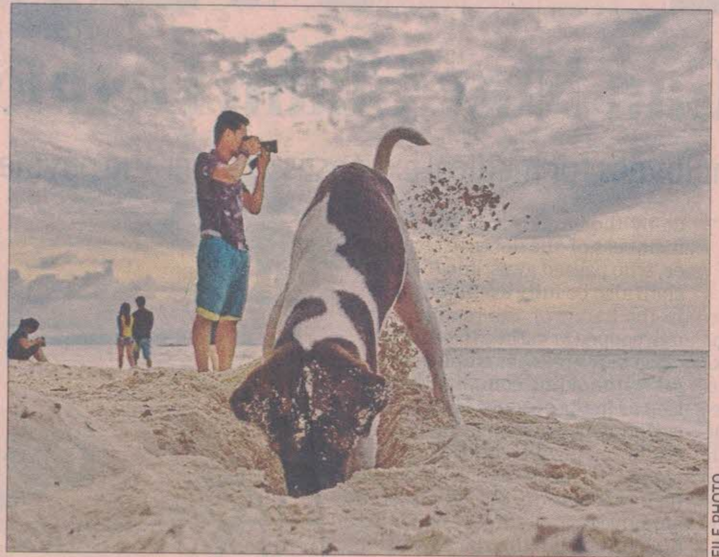
The problem before the government is how to meet this huge borrowing programme. There is no appetite for it in either domestic or external market. It will have to have the support of RBI. It is in this context some have talked about 'printing notes'. This implies that RBI will pick up directly the government bonds and pay for it by creating money. This is a system which we abolished in early 1990s. The Fiscal Responsibility and Budget Management (FRBM) Act also reiterates it.

Pushing Liquidity

The other alternative is for RBI to provide additional liquidity to banks and other institutions, and enable them to subscribe to new loans floated by the government. This is indirect monetisation of debt, and what is currently happening. Of the two methods, indirect is preferable because in the direct method, interest rate becomes a negotiated figure. The plea for enhanced government expenditure implies heavy borrowing that, in turn, results in expanded liquidity.

It is this expanded liquidity that poses an additional problem. RBI has introduced several measures— conventional and non-conventional — to expand liquidity. Some are directly related to purchase of government paper. The heavy borrowing programme will require RBI to push more and more liquidity as the year goes on. The impact of this will be on prices. Overall inflation will go up.

The expectation of RBI on inflation is somewhat moderate. In the recently released monetary policy statement, RBI has projected a consumer price index (CPI) inflation of 5.1% for 2021-22 with a quarterly decomposition, indicating 5.2%, 5.4%, 4.7% and 5.3% in successive quarters. It may be recalled that the CPI inflation rate at 6.2% in 2020-21 had exceeded the upper limit of the monetary policy tolerance range of 6%. The consumer price inflation touched 6.3% in May 2021.



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Get your head out of the sand

However, food price inflation was 5.01%, indicating non-food inflation running at a high level. In May 2021, wholesale price inflation touched an unusually high level of 12.94%. One has to wait and see whether these are just one-off flashes.

Keeping Interest Low

GoI and RBI are keen to keep the interest rate low despite this heavy borrowing. According to the latest monetary policy statement, the y-o-y growth rate in reserve money is 12.4% (as on May 28). So far, the impact of the injection of liquidity has been modest. Money supply (M3) growth is lower at 9.9% and credit growth is only 6% (as on May 21).

What these numbers show is that the money multiplier is low. This may be attributed to two reasons: low credit expansion and larger leakage in the form of currency. The potential, however, for money supply growth is large. Even now the stock of money in relation to output (GDP) is higher.

The discussion on inflation, in the monetary policy statement as well as in the minutes of the Monetary Policy Committee (MPC), focuses entirely on supply availability and bottlenecks in the distribution of commodities. The output gap is certainly relevant. But equally relevant in an analysis of inflation is liquidity in the system, and its impact on output and prices.

Certainly, larger availability of liquidity through extended credit is intended to stimulate production. But equally it has a demand effect. What is relevant is 'monetary demand'. We should not treat what is happening to inflation as simply 'cost-push'. The specific point to note is that policy action itself has an impact on inflation.

High government expenditure will require higher borrowing that, in turn, will require larger support from RBI, which will have its own effect on prices. Policymakers need to decide on the appropriate trade-off between growth and inflation. If inflation is the price to pay for real growth, policymakers must say so. One cannot simply wish away the impact of reserve money expansion flowing from higher borrowing.

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Rangarajan is former governor, Reserve Bank of India. Srivastava is former director, Madras School of Economics