India's monetary policymakers can't ignore the impact of money supply or liquidity on inflation

Hear the Liquidity Sloshing

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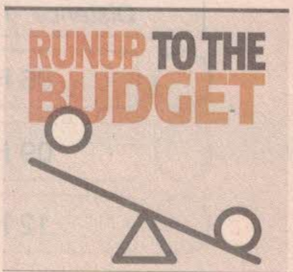
Inflation has emerged as an important concern in most countries, including the US and India. In the US, the consumer price index (CPI) inflation had, in December 2021, touched a very high level of 7%. One year earlier, it was only at 1.4%. In India, CPI inflation stood at 5.59% in December.

As early as January 2020, it had touched 7.59%. Thereafter, it started coming down. However, it touched again a high of 7.61% in October 2020. It again started coming down, and after touching a low of 4.35% in September 2021, it has risen to the present level. It must be noted that the wholesale price index (WPI) had remained at a double-digit level since April 2021. The implicit price deflator in the national income estimates of 2021-22 released recently is above 8%. These other indicators of price behaviour cannot also be ignored.



In this context, two questions arise. One relates to what the acceptable level of inflation in the context of the impact of Covid-19 is. The second centres around the factors that should be taken into account while analysing the cause of inflation.

On the first question, the US Federal Reserve has taken the view that the current level of inflation in the US is too high and has, therefore, started initiating measures to tighten monetary policy. Indian policymakers have, so far, taken the view that growth is important and that the level of CPI may moderate in the future. They have, until now, continued with the same policy stance of being accommodative. This is partly a matter of personal judgement and partly dependent on expectations of the future behaviour of inflation.

Getting a Grip on Inflation

This aspect is related to the second question of the causes of inflation. One may not go the whole hog with Milton Friedman who had said that inflation was always a monetary phenomenon. By the same token, we cannot completely neglect the impact of money or liquidity. Not only policymakers, but also policy analysts — and editorial writers — tend to ignore this. Their discussions are focused on supply bottlenecks and disruptions as the key factor influencing inflation.

The distinction between the behaviour of 'general price level' and the prices of individual commodities is completely overworked. The present argument appears to be that there is no demand pressure, and supply considerations alone affect prices. It is further argued that as the supply situation eases because of the removal of Covid restrictions, prices will come down.

Even if one were to look at the problem from the demand side, what is relevant is 'monetary demand'. In the US case, it is very clear. It is the extraordinary increase in liquidity and the ballooning of the balance sheet of the Fed that has finally resulted in price increases not seen in the last several decades.

RBI, GoI, don't forget the iceberg

It is interesting to look at the data on liquidity in India a little more closely. The table enclosed provides the information on liquidity growth. Reserve money growth since April 2021 has remained high, although year-on-year growth has shown some decline. Money supply growth has been subdued — that is, less than the growth rate of reserve money. It is not far-fetched to see the cause of somewhat lower growth in money supply.

The credit growth has been lower and, therefore, the money multiplier is low. Supply shocks can only affect relative prices, but not the general price level, unless they (supply shocks) are accompanied by liquidity expansion.

The case for an easy money policy in the context of a situation such as the one faced after the advent of Covid-19 can be well understood and appreciated. But its possible impact on price level should not be missed. The focus on the level of interest rate should not hide the relationship between quantity (liquidity) and price (interest rate). The resurgence of the term 'quantitative easing' cannot be overlooked.

While making forecast of inflation, policymakers must take into account the possible impact of their own actions. It is well understood that the process of 'money creation' involves a process of 'credit creation'. Thus, the expansion of money has a dual effect — on 'output' and on 'demand' — and, therefore, on prices. The demand effect is immediate, while the output effect is lagged and sometimes uncertain.

Liquidity Growth in India, 2021

(₹ in crores)

	Reserve Money		Broad Money	
	Stock at End of Period	Y-o-Y Growth Rate	Stock at End of Period	Y-o-Y Growth Rate
April	35,85,499.95	18.74	1,89,80,415.30	11.43
May	37,05,431.46	18.32	1,90,12,125.69	10.34
June	36,98,987.35	16.92	1,91,68,204.11	10.7
July	37,15,957.38	16.80	1,93,72,714.42	9.91
Aug	36,79,192.14	15.22	1,93,30,427.06	9.53
Sept	36,59,381.97	14.74	1,93,97,300.04	9.34
Oct	37,03,450.87	14.15	1,95,24,125.56	9.66
Nov	37,36,106.80	12.76	1,96,46,645.57	9.53
Dec	37,44,265.98	12.98	1,97,41,867.49	9.34

Source: RBI

Output as the Peg

This approach is a far cry from the original quantitative theory of money. It moves away from the assumption of constant 'output' or 'transactions'. We need to be aware that after two years, output is back only to where it was in April 2020. Meanwhile, money supply has increased, which will stay at that level.

Monetary policy is always confronted with the problem of not only what to do but also when to do — or not to do. The time has come for India's monetary authorities not only to 'pause' but also to give a signal of a change in stance. This does not mean that the growth recovery will be impaired. The biggest gainer of the expanded liquidity so far is the government. Keeping the interest rate low artificially has its own implications. 'Financial repression' can also do some damage.

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