GUEST VIEW

The conundrum of inflation: It's liquidity that plays the lead role

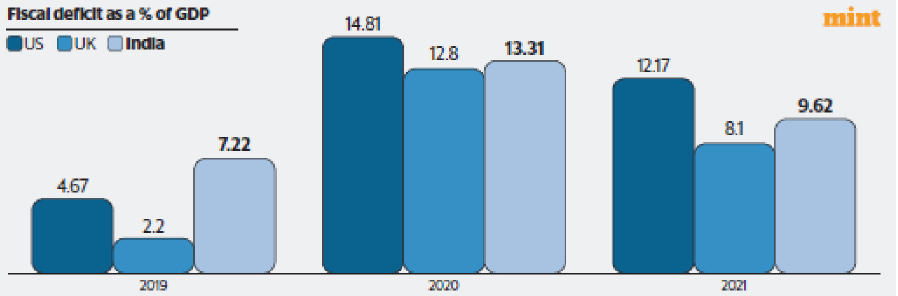
It's the central bank's response in terms of monetary expansion or contraction that impacts an economy's general price level

C. RANGARAJAN
is former chairman, Economic Advisory Council to the Prime Minister, and former governor, Reserve Bank of India

ISTOCKPHOTO

Fiscal expansion in response to the pandemic

While the US tripled its fiscal deficit in 2020 from 2019 and the UK increased it five times after the covid outbreak, India's increase in 2020-21 over 2019-20 was less dramatic.



Note: India's figures are for the gross fiscal deficit of its Centre and states for fiscal years 2019-20, 2020-21 and 2021-22

Source: Author's compilation

SATISH KUMAR/MINT

The world is currently caught in the grip of severe inflation. Consumer inflation in the US touched 8.3% in August 2022. This is a level of inflation the US had not seen for several decades. The UK's inflation touched 9.9% in August. India's consumer price inflation was 7.4% in September 2022. It has been above the 6% upper limit of the inflation band for more than nine months. Is there a common factor responsible for this high level of inflation across countries? Very often, policymakers point to the sudden surge in petroleum prices immediately after the Russia-Ukraine war as a major cause. The focus on supply bottlenecks and disruptions as key factors influencing inflation fails to make a distinction between the behaviour of an economy's 'general price level' and the prices of individual commodities. Given a budget constraint, sharp increases in individual prices will only result in an adjustment of relative prices. It is the policy response to increasing individual prices at the macro level in terms of expanding or contracting liquidity that impacts the general price level or inflation. Several decades ago, strangely while addressing an Indian audience, Milton Friedman said, "It is true that the upward push in wages produced inflation, not because it was necessarily inflationary but because it happened to be the mechanism which forced an increase in the stock of money." Thus, while individual prices can trigger inflation, it is the adjustment in the macro level of liquidity that sustains inflation.

What has happened in the current situation is clear. The response to covid across countries was to raise government expenditures at a time when revenues were falling. The net result was a substantial rise in government fiscal deficits which could be financed only with the support of central banks. The US fiscal deficit tripled in 2020 over 2019. The UK's fiscal deficit increased by 5 times during the same period (Table 1). The US Federal Reserve's assets stood at $4.17 trillion on 1 January 2020, and in April 2022, they stood at $8.96 trillion. This massive expansion in assets is the consequence of quantitative easing (QE). Most central banks followed a similar path. A natural consequence is the unusual level of inflation which we are witnessing. I pointed out to the dilemma central banks faced in 2020 (see my article 'Devil, Us, the Deep Blue Sea' in *Economic Times*, 2 April 2020). The Indian situation is not very different, even though the fiscal deficit increase was more moderate than in the US and UK; this also explains why our inflation is somewhat lower.

The inflation that we are witnessing the world over is policy induced, however well intentioned and needed that policy might have been. The lesson to draw is that if we want to control inflation, we must contain the growth of liquidity interpreted in a broad sense.

Are we facing another dilemma in today's context? It is argued that a strong focus on inflation control may jeopardize recovery efforts after covid. One country which sees no dilemma is the US. Inflation having hit an unbelievably high level, the Fed chairman is categorical that the Fed's sole objective right now is to control inflation. Fed Chairman Jerome Powell said, "The overreaching focus right now is to bring inflation back down to our 2% goal." He added, "The first lesson is that central banks can and should take responsibility for delivering low and stable inflation."

This attitude is explained by the low tolerance for inflation in the US. The country's economic system is not geared to adjust to high inflation. The UK is caught in a dilemma of how to provide support to citizens who are suffering because of the sudden increase in fuel prices and at the same time contain its fiscal deficit to control inflation. In inflation-targeting countries like India, the dilemma should be less. After all, the upper limit of the band provides the basis for action. Once the upper limit is crossed, the primary goal should be clear. Action must be directed first at bringing inflation below the upper limit. In fact, the choice between control of inflation and safeguarding growth is not that clear. Inflation hits the poor even more than other sections of society. In fact, the problem with inflation is its differential impact.

Will a rise in the policy interest rate help bring down inflation? The transmission mechanism here is somewhat of a 'black box'. John Maynard Keynes and Ralph George Hawtrey talked of the respective roles of long-term and short-term rates of interest. There are different interpretations. The objective is to bring down aggregate demand. Can this happen only with a decline in output? We shall not go into this here now. But it is important to note that central banks cannot order interest rates. They have to take action to make it happen. In fact, in the US, the Federal Open Market Committee's instructions to the Market Desk on 21 September begin by saying, "Undertake open market operations as necessary to maintain the federal funds rate in a target range of 3 to 3-1/4 per cent." Liquidity contraction or expansion is concomitant with a central bank's decision to raise or lower the policy rate. These are not two independent decisions. Post-2008-09, quantitative easing and contraction have come into usage, emphasizing quantity as well.