

IMPACT OF VARIOUS POLICIES OF FINANCIAL MARKETS



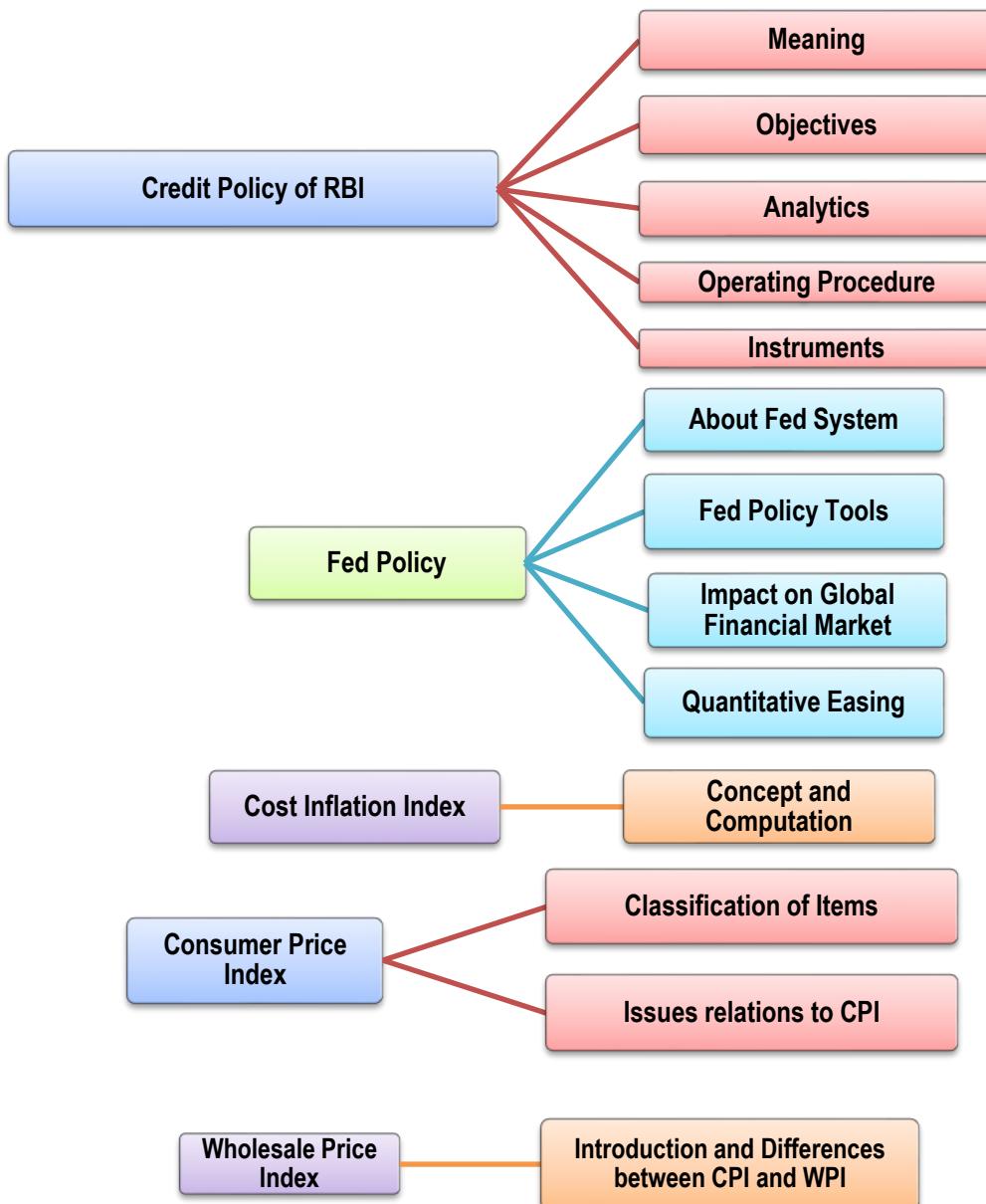
LEARNING OUTCOMES

After going through the chapter student shall be able to understand:

- Credit Policy of RBI
- Fed Policy
- Inflation Index, CPI, WPI, etc.

CHAPTER OVERVIEW

Impact of Various Policies of Financial Markets





1. CREDIT POLICY OF THE RESERVE BANK OF INDIA (RBI)

1.1 Meaning of Credit Policy

The credit policy is basically a plan of action executed by the Reserve Bank of India (RBI) on behalf of the Government of India to control and regulate the demand for and supply of money with the public and the flow of credit i.e. money into the economy. It refers to the use of credit policy instruments which are at the disposal of central bank to regulate the availability, cost and use of money and credit to promote economic growth, price stability, optimum levels of output and employment, balance of payments equilibrium, stable currency, or any other goal of government's economic policy.

1.2 Objectives of Credit Policy

The various objectives of Credit Policy are as follows:

(i) **Maintenance of Price Stability**—One of the foremost responsibilities of RBI is to control inflation and maintain the stability of prices. For this RBI uses interest rates as a tool to maintain inflation at its desired levels. If the RBI feels that the inflation is high, then it increases the interest rates to curb demand in the overall market & to tune the credit growth in economy which in turn leads the inflation to cool down. Similarly, if RBI feels the inflation is too low and wishes to increase inflation then it either reduces the interest rates or pumps in money in the system by different means to increase the demand in the economy and in turn increases the inflation.

(ii) **Achieving Economic Growth** – It is also one of the most important objectives of the Credit Policy of RBI. The purpose is to achieve economic growth through various means which will be discussed later. In fact, the primary objective is to maintain a judicious balance between maintenance of price stability and achieving economic growth. So, achieving economic growth is not a direct objective. GDP growth and job creation is primarily the government function. Credit policy is primarily targeted to keep inflation in check and maintain sufficient liquidity in the system which will spur demand and leads to economic growth.

(iii) **Exchange Rate Stability** – The aim is to maintain exchange rate stability, so the imports are cheaper, and exporters increase their exports and earn precious foreign exchange. If RBI finds that the Dollar is appreciating, and INR is depreciating, and it wants to support INR from further depreciation then it will take measures that will allow more dollar inflow in the system thereby appreciating the rupee, and thus, supporting INR. For example, allowing banks temporarily to raise

fresh Foreign Currency Non-Resident Bank i.e., FCNR(B) and Non-Resident External (NRE) deposits for a limited period.

(iv) External Balance of payment equilibrium – The balance of payment is basically economic transactions of the residents of a country with the rest of the world during a given period of time. When we add up all the demand for foreign currency and all the sources from which it comes, these two amounts are necessarily equal and thus the overall account of the balance of payments necessarily balance or must always be in equilibrium.

(v) Adequate flow of credit to productive sectors – It is the responsibility of the Central Bank to ensure that regular, easy, and smooth availability of money to the needy sectors of the economy is rendered on a continuous basis. This will help the industry to pump in the required money to boost their production. This will automatically increase employment as the companies will hire more people to enhance their capacity. This in turn will lead to a higher standard of living for the people.

(vi) Maintaining a moderate structure of interest rates to enhance investments – The RBI plays an important role in the management of the rate of interest. And the fate of many industries depends upon the interest rate policy pursued by the Central Bank. They expect that interest rates be reduced so that loans can be available at a cheaper rate. On the other hand, in case of inflation, the general perception is to increase the rate of interest. Therefore, the RBI evaluates the pros and cons of its every prospective decision and decides if interest rate policy is to be pursued.

Hence, the role of RBI is to tread on a cautious path. People expect that inflation shall be contained and stay within a reasonable limit so that goods and services are available to them in a cheap manner. At the same time, people expect that unemployment should be reduced and more and more jobs should be available. So, a tradeoff is required between controlling inflation and rising unemployment.

1.3 Analytics of Credit Policy

There are basically four different mechanisms through which monetary policy influences the price level and the national income. These are:

(i) Interest Rate Channel – Interest rates increase the cost of capital and real cost of borrowing for firms with the result that they cut back on their investment expenditure. Similarly, general public facing the heat of high interest rates cut back on their purchase of homes, cars, air-conditioners and other goods. So, a decline in aggregate demand results in the decline in aggregate output and goods.

On the other hand, a decrease in interest rates has the opposite effect of a decrease in cost of capital of firms and cost of borrowing for households.

(ii) **Exchange Rate Channel** – Appreciation of the domestic currency makes domestically produced goods more expensive as compared to foreign-produced goods. The reason is that import from countries outside India will become cheaper and it will make the goods produced in India dearer in comparison. This will cause the net export to fall (because expensive good produced in India will have to be sold at a higher price and it will find few takers outside India). Consequently, domestic output and employment will also fall.

On the other hand, as the rupee depreciates, exports become more profitable, because the exporter earns more rupees for exchanging dollar. On the other hand, imports become expensive as the importer needs to pay more rupees for the dollars billed. Industries linked to exports like pharma and IT benefit with depreciation, whereas those industries linked to imports (or having vital components of their product imported) must bear higher input cost, which is ultimately passed on to the end users.

(Source: *Financial Express*)

China used the strategy to devalue their currency “Yuan” and keep the exports profitable for local vendors and thereby infusing jobs and growth in their country.

(iii) **Quantum Channel (relating to money supply and credit)** – Two things are worth mentioning in this regard – the bank lending (credit) channel and the balance sheet channel. Credit channel operates by altering the access of firms and households to bank credit. Most business organizations depend on bank loans for their borrowing needs. To restrict the flow of credit in times of inflation, the RBI sells government securities to commercial banks and the public and squeeze money from them. This makes the firms which are dependent on bank loans cut back on their spending on investment. This will diminish aggregate output and employment following a reduction in money supply.

Now, we shall look at how the balance sheet channel works. The direct effect of monetary policy on the balance sheet is that it will show the interest cost and increase in payments through loan repayments. An indirect effect is that the same increase in interest rate works to reduce the capitalized value of the firm's fixed assets. This will also raise the company's cost of capital and consequently, precipitate a reduction in production and output.

(iv) **Asset Price Channel** – The standard asset price channel indicates that changes in credit policy effects output, employment, and inflation. An increase in interest rates in debt securities makes them more attractive to investors than equity. This leads to a fall in the share prices which resulted in the consequent fall in consumption, production, and employment. These also affect the overall financial wealth of the investors.

1.4 Operating Procedure and Instruments

The operating framework of monetary policy refers to how the various aspects of monetary policy are implemented. These aspects are briefly explained as below:

Choosing the operating target –The operating target to the variable (for e.g. inflation) that monetary policy can influence with its actions.

Choosing the intermediate target - (e.g. economic stability) is a variable which central bank can hope to influence to a reasonable degree.

Choosing the policy instruments -The credit policy instruments are the various tools that a central bank can use to influence money market and credit conditions and pursue its monetary policy objectives.

The day-to-day implementation of monetary policy by central banks through various instruments is referred to as 'operating procedures'.

1.5 The instruments of Credit Policy

The various credit policy instruments are explained in the following paragraphs:

(i) **Cash Reserve Ratio (CRR)**: Cash reserve ratio is the amount which the commercial banks must maintain as cash deposit with the Reserve Bank of India. An important thing to note here is that commercial banks do not get any interest from RBI on CRR. RBI may increase the CRR if it thinks that there is large amount of money supply in the economy. Conversely, it will decrease the CRR if it is of the opinion that inflation is in control and the industry needs a monetary boost up. The reduction in CRR will provide more money in the hands of commercial banks which will pass it on to industry. More money in the hands of industry will boost production, consumption, and employment.

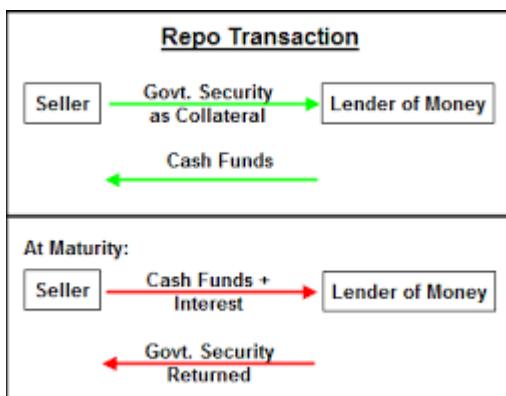
(ii) **Statutory Liquidity Ratio (SLR)**: Statutory Liquidity Ratio is the amount which commercial banks must keep it with itself. So, SLR is the amount of money which banks must always keep in its custody. SLR is also a very powerful tool to control liquidity in the economy. To encourage industries to boost up their production, SLR may be decreased to put more money in the hands of commercial banks. An increase in SLR is used as an inflation control measure to control price rise.

Maintenance of CRR and SLR are a part of what is known as the 'Fractional Reserve System' in Central Banking. Fractional Reserves are a part of the wider Quantitative Monetary Policy.

(iii) **Liquidity Adjustment Facility (LAF)**: Under this facility, the commercial banks can borrow from RBI through the discount window against the collateral of securities like commercial bills,

treasury bills or other eligible papers. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the LAF.

Repo transaction is defined as an instrument through which commercial banks borrow from RBI. So, it is basically borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed. In other words, repo is a money market instrument, which enables collateralized short-term borrowing and lending through sale/purchase operations in debt instruments.



Source: <https://www.assignmentpoint.com/business/finance/repurchase-agreement-definition.html>

Reverse Repo transaction, on the other hand, is an instrument through which RBI borrows from commercial banks by giving them securities. So, reverse repo is defined as an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

(iv) Margin Standing Facility (MSF): Margin Standing Facility announced by the Reserve Bank of India (RBI) in its Monetary Policy, 2011-12 refers to the facility under which scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF facility up to a limit at a penal rate of interest.

The minimum amount which can be assessed through MSF is ₹ 1 crore and more will be available in multiples of ₹ 1 crore. The MSF would be the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility on which the rates are lower compared to the MSF.

(v) Market Stabilization Scheme: Under the market stabilization scheme, the Government of India borrows from the RBI and issues treasury bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows. Now, with the introduction of Liquidity Adjustment Facility (LAF) i.e. Repo and Reverse Repo mechanism, bank rate has become dormant as an instrument of monetary policy.

The bank rate has been aligned to the Marginal Standing Facility (MSF) rate and therefore, as and when the MSF rate changes alongside policy repo rate changes, the bank rate also changes automatically. Now, bank rate is used only for calculating penalty on default in the maintenance of Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

(vi) **Open Market Operations:** Open Market Operation is basically a tactic employed by the RBI to control the liquidity in the economic system. When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby reducing excess rupee flowing in the Indian economy. Similarly, when there is a tight liquidity situation in the economy RBI will buy securities from the market, thereby releasing money (rupee) into the system. Maintaining short-term liquidity is very important because if it is not maintained then the short term money market rates (MIBOR) will be impacted, which will have its impact on short term lending and borrowings.

(vii) **Focusing Banks to promote lending to a particular sector:** RBI may change the category of the sector in which it wants more lending to be done by commercial banks. For example, it can include the sector in and as priority sector or it can include a particular sector under the definition of infrastructure to promote more funding in that sector.

Furthermore, infrastructure status helps easier access to Institutional credit and reduction in cost of borrowing.



2. FED POLICY

2.1 About the Federal Reserve System

The Federal Reserve System is the Central Bank of the United States.

It performs five general functions to promote the effective operation of the U.S. economy and, more generally, the public interest. The Federal Reserve:

- **conducts the nation's monetary policy** to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy;
- **promotes the stability of the financial system** and seeks to minimize and contain systematic risks through active monitoring and engagement in the U.S. and abroad;
- **promotes the safety and soundness of individual financial institutions** and monitors their impact on the financial system as a whole;
- **fosters payment and settlement system safety and efficiency** through services to the banking industry and the U.S. government that facilitate U.S. dollar transactions and payments; and

- promotes consumer protection and community development through consumer-focused supervision and examination, research and analysis of emerging consumer issues and trends, community economic development activities, and the administration of consumer laws and regulations.

2.2 Fed Policy Tools

The techniques or tools employed by the US Federal Reserve as a part of Fed Policy have been discussed in brief in the following paragraphs. The purpose of the Fed Policy tools is more or less the same as employed by the Reserve Bank of India which has been discussed in detail in the preceding paragraphs.

(i) **Open Market Operations:** It is the purchase and sale of securities in the open market by a central bank that are key tools used by the Federal Reserve in the implementation of monetary policy.

(ii) **The Discount Rate:** The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility--the discount window. The Federal Reserve Banks offer three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. All discount window loans are fully secured.

Under the primary credit program, loans are extended for a very short term (usually overnight) to depository institutions in generally sound financial condition. Depository institutions that are not eligible for primary credit may apply for secondary credit to meet short-term liquidity needs or to resolve severe financial difficulties. Seasonal credit is extended to relatively small depository institutions that have recurring intra-year fluctuations in funding needs, such as banks in agricultural or seasonal resort communities.

(iii) **Reserve Requirements:** Reserve requirements are the amount of funds that a depository institution must hold in reserve against specified deposit liabilities. Within limits specified by law, the Board of Governors has sole authority over changes in reserve requirements. Depository institutions must hold reserves in the form of vault cash or deposits with Federal Reserve Banks.

(iv) **Interest on Required Reserve Balances and Excess Balances:** The Federal Reserve Banks pay interest on required reserve balances and on excess reserve balances. The interest rate on required reserves (IORR rate) is determined by the Board and is intended to effectively eliminate the implicit tax that reserve requirements used to impose on depository institutions.

(v) **Overnight Reverse Repurchase Agreement Facility:** When the Federal Reserve conducts an overnight RRP, it sells a security to an eligible counterparty and simultaneously agrees to buy the security back the next day.

(vi) **Term Deposit Facility:** Funds placed in and thereby drain reserve balances from the banking system.

(Source: www.federalreserve.gov)

2.3 Fed Funds Rate and its impact on Global Financial Market

The Fed Funds Rate is the interest rate at which the top US banks borrow overnight money from common reserves. All American banks are required to park a portion of their deposits with the Federal Reserve in cash, as a statutory requirement.

Fed fund rate gives the direction in which US interest rates should be heading at any given point of time. If the Fed is increasing the interest rates, lending rates for companies and retail borrowers will go up and vice versa. In India, hike in repo rate may not impact the countries outside India. On the other hand, US interest rates matter a lot to global capital flows. Some of the world's richest institutions and investors have their base in the USA. They constantly compare Fed rates with interest rates across the world to make their allocation decisions.

Any changes in the Fed Fund Rates impact the domestic borrowing market to a large extent. For instance, if the Fed rates go up, it will make the RBI hesitant in cutting rates at that time. The reason is that if RBI cut rates it will lead to heavy pullout of foreign investors from the Indian bond market.

Further, US interest rates matter to foreign stock investors in India also. The reason is zero or near zero returns on safe investments in the US. But, if the Fed rates go up, it may lead to mass exodus of foreign investors from the Indian Stock Market because higher returns in the form of interest is available there.

2.4 Quantitative easing (QE)

It is a monetary policy strategy used by central banks like the Federal Reserve. With QE, a central bank purchases securities to reduce interest rates, increase the supply of money and drive more lending to consumers and businesses. The goal is to stimulate economic activity during a financial crisis and keep credit flowing.

What is Quantitative Easing (QE)?

When a central bank decides to use QE, it makes large-scale purchases of financial assets, like government and corporate bonds and even stocks. This relatively simple decision triggers powerful

outcomes: The amount of money circulating in an economy increases, which helps lower longer-term interest rates. This lowers the cost of borrowing, which spurs economic growth.

By buying longer maturity securities, a central bank is aiming to lower longer-term market interest rates. Contrast this with one of the main tools used by central banks: Interest rate policy, which targets shorter-term market interest rates.

When the Federal Reserve adjusts its target for the federal funds rate, it's seeking to influence the short-term rates that banks charge each other for overnight loans. The Fed has used interest rate policy for decades to keep credit flowing and the U.S. economy on track.

When the fed funds rate was cut to zero during the Great Recession, it became impossible to reduce rates further to encourage lending. Instead, the Fed deployed QE and began purchasing mortgage-backed securities (MBS) and Treasuries to keep the economy from freezing up.

Central banks like the Fed send a strong message to markets when they choose QE. They are telling market participants that they're not afraid to continue buying assets to keep interest rates low.

How Does Quantitative Easing Work?

Quantitative easing works by making large-scale asset purchases. In response to the coronavirus pandemic, for example, the Fed has begun purchasing longer-maturity Treasuries and commercial bonds.

For example:

Here's how the simple act of buying assets in the open market changes the economy (mostly) for the better:

The Fed buys assets. The Fed can make money appear out of thin air—so-called money printing—by creating bank reserves on its balance sheet. With QE, the central bank uses new bank reserves to purchase long-term Treasuries in the open market from major financial institutions (primary dealers).

New money enters the economy. As a result of these transactions, financial institutions have more cash in their accounts, which they can hold, lend out to consumers or companies, or use to buy other assets.

Liquidity in the financial system increases. The infusion of money into the economy aims to prevent problems in the financial system, such as a credit crunch, when available loans decrease or the criteria to borrow money drastically increase. This ensures the financial markets operate as normal.

Interest rates decline further. With the Fed buying billions worth of Treasury bonds and other fixed income assets, the prices of bonds move higher (greater demand from the Fed) and yields go lower (bondholders earn less). Lower interest rates make it cheaper to borrow money, encouraging consumers and businesses to take out loans for big-ticket items that could help spur economic activity.

Investors change their asset allocations. Given the now-lower returns on fixed income assets, investors are more likely to invest in higher-returning assets—like stocks. As a result, the overall stock market could see stronger gains because of quantitative easing.

Confidence in the economy grows. Through QE, the Fed has reassured markets and the broader economy. Businesses and consumers may be more likely to borrow money, invest in the stock market, hire more employees, and spend more money—all of which helps to stimulate the economy.

The Downsides of QE

Implementing QE comes with potential downsides, and its impact is not universally beneficial to everyone in the economy. Here are some of the dangers:

(i) QE May Cause Inflation

The biggest danger of quantitative easing is the risk of inflation. When a central bank prints money, the supply of dollars increases. This hypothetically can lead to a decrease in the buying power of money already in circulation as greater monetary supply enables people and businesses to raise their demand for the same amount of resources, driving up prices, potentially to an unstable degree.

(ii) QE Isn't Helpful for Everyone, May Cause Asset Bubbles

Some critics question the effectiveness of QE, especially with respect to stimulating the economy and its uneven impact for different people. Quantitative easing can cause the stock market to boom, and stock ownership is concentrated among Americans who are already well-off, crisis or not.

By lowering interest rates, the Fed encourages speculative activity in the stock market that can cause bubbles and the euphoria can build upon itself so long as the Fed holds on to its policy. So, this is basically a confidence game; market participants think the Fed has their back and as long as they do, there's limited fear.

(iii) QE May Cause Income Inequality

A final danger of QE is that it might exacerbate income inequality because of its impact on both financial assets and real assets, like real estate. It has benefited those who do well when asset prices go up.

This potential for income inequality highlights the Fed's limitations. An expert said in this regard that the central bank doesn't have the infrastructure to lend directly to consumers in an efficient way, so it uses banks as intermediaries to make loans. "It is really challenging for the Fed to target individuals and businesses that are hardest hit by an economic disruption, and that is less about what the Fed wants to do and more about what the Fed is allowed to do. (Source: www.forbes.com)



3. COST INFLATION INDEX (CII)

Cost Inflation Index is a measure of inflation that is used for computing long-term capital gains on sale of capital assets. It is prescribed by the central government every year and useful in the calculation of the indexed value of capital assets. It helps a taxpayer in computing the actual long-term gain or loss on selling of capital assets and allows the taxpayer to factor the impact of inflation on the cost of their assets.

To calculate the indexed cost of acquisition we must divide the Cost Inflation Index or CII for year in which asset is sold by the Cost Inflation Index or CII for a year in which asset is bought, then multiplied with the purchase price of the asset to arrive at the indexed cost of acquisition which is the actual or true cost used at the time of tax computation.

Since the government levies a tax on such transactions, the owner would be required to pay a large amount as tax. To avoid paying a large sum towards tax, the purchase price of the asset can be indexed to show the asset's value as per its current value, considering inflation by increasing its value. In this manner, the profit derived from the sale would be lower, thus reducing the tax on capital gains.

Thus, indexation helps the actual value of the asset to reflect at its present market rates, considering the reduction in its value due to inflation.

When selling an asset, the purchase price is referred to as the indexed cost of acquisition. The cost inflation index (CII), therefore, is the indexed price that the asset is purchased at. The CII for a particular year is fixed by the government and released before the accounting year ends, for the purpose of tax computation.

Computation of Cost Inflation Index

Cost Inflation Index (CII) = CII for the year the asset was transferred or sold / CII for the year the asset was acquired or bought.

The above formula for the computation of CII has been explained with the help of an example:

Example

Suppose you purchased a house for ₹ 25 lakhs in Jan 2005 and sold it for ₹ 70 lakhs in Jan 2015. Your profit or capital gain is ₹ 45 lakhs.

The CII for the year the apartment was bought in is 406. The CII for the year the apartment was sold is 1081.

Now, the cost inflation index = CII for the year the asset was transferred or sold / CII for the year the asset was acquired or bought = $1081/406 = 2.66$

While computing tax, CII is multiplied with the purchase price to arrive at the indexed cost of acquisition. This is the actual cost of the assets.

Therefore, the indexed cost of acquisition = $25,00,000 \times 2.66 = ₹ 66,50,000$

And the long term capital gain = sale value of the asset- indexed cost of acquisition

$$= 70,00,000 - 66,50,000 = ₹ 3,50,000$$

The tax liability if you use the indexation method is charged at 20 percent. The tax liability will be $20\% \times 3,50,000 = ₹ 70,000$.

If you do not use the indexation method, the tax is payable at 10% on the capital gain. The capital gain in this case is sale price of the apartment – cost of acquisition = $70,00,000 - 25,00,000 = ₹ 45,00,000$. The capital gains tax is $10\% \times 45,00,000 = ₹ 4,50,000$.

Therefore, when indexation benefit is taken, it helps you in saving taxes. It helps you adjust the purchase price of the house with the current market prices.



4. CONSUMER PRICE INDEX (CPI)

A Consumer Price Index (CPI) is designed to measure the changes over time in the general level of retail prices of selected goods and services that households purchase for the purpose of consumption. Such changes affect the real purchasing power of consumers' income and their welfare. The CPI measures price changes by comparing, through time, the cost of a fixed basket of commodities. The basket is based on the expenditures of a target population in a certain reference period. Since the basket contains commodities of unchanging or equivalent quantity and quality, the index reflects only pure price. Traditionally, CPI numbers were originally introduced to provide a measure of changes in the living costs of workers, so that their wages could be compensated to the changing level of prices. However, over the years, CPIs have been widely used as a macroeconomic indicator of inflation, and as a tool by Government and Central Bank for targeting inflation and

monitoring price stability. CPI is also used as deflators in the National Accounts. Therefore, CPI is considered as one of the most important economic indicators.

Given the many uses of CPIs, it is unlikely that one index can perform equally satisfactory in all applications. Therefore, there is a practice of compiling several CPI variants for specific purposes. Each index should be properly defined and named to avoid confusion. The purpose of CPI should influence all aspects of its construction.

4.1 Classification of Items

Classification is the first step in compiling the CPI because its sub-aggregates must be defined in such a way that expenditure weights and prices will relate precisely to the coverage of the sub-aggregates. It establishes a hierarchical framework from whose boundaries the representative items for inclusion in the index (and sometimes the outlets) will be defined and drawn. In a broad sense, classification is a procedure in which items are organized into categories based on information on one or more characteristics inherent to the items. In recent past, countries used their own distinct systems for classifying the range of products covered by their CPI. Most countries have now, however, moved to the international standard classification COICOP (Classification of Individual Consumption according to Purpose).

To ensure better comparability with CPIs of other countries, it is desirable to have the classification of items synchronized with COICOP. At the same time, it is also important to make it relevant to the Indian context by making it comparable to groups and sub-groups being followed in the CPI series compiled in the country. Accordingly, all consumption items have been classified under various Groups, Categories, Sub-groups, and Sections.

(Source: *Ministry of Statistics and Programme Implementation*)

4.2 Issues relating to Consumer Price Index (CPI)

Some of the issues relating to Consumer Price Index (CPI) which have been in vogue for quite some times have been discussed in the following points in order to have a good glimpse of the actual impact of CPI to the consumers in India.

(1) 90-95% of the index (CPI) is not affected by interest rates as the amount spent on household is not affected by the rate changes. This includes food products (covering 48% in index), housing or fuel expenses. These are fixed costs and had to be spent irrespective of the rate of inflation.

(2) Concept of CPI does not make sense to the household. A 2% CPI does not seem convincing to a housewife who believes that prices of most of the commodities are on the higher side than that

reflected by CPI. So, it is frustrating for the consumer who after every fall in rate of inflation finds that actual prices are on the much higher side.

For example, prices of onions suddenly increase from ₹ 30 per kg. to ₹ 80 per kg. Similarly, the prices of Tur Dal increase from ₹ 40 per kg. to ₹ 200 per kg in a very short span of time. However, prices came down slowly and then settled at ₹ 80-100 per kg. So, prices increase at a very fast rate but came down after taking a lot of time and that too, the reduced price is generally at a much higher level than the previous one, as explained in the previous sentence with the help of an example.

(3) Lastly, a general view is that HRA allowance paid to Central Government employees would tend to raise inflation. However, if the government employee is residing in a government accommodation, HRA is automatically deducted from the pay slip of an employee. On the other hand, if an employee is not staying in government accommodation the amount in the pay slip will go up. Therefore, an increase in HRA may not translate into higher cost of living or higher retail demand.



5. WHOLESALE PRICE INDEX (WPI)

The Wholesale Price Index (WPI) measures the average change in the prices of commodities for bulk sale at the level of early stage of transactions. The index basket of the WPI covers commodities falling under the three major groups namely Primary Articles, Fuel and Power and Manufactured products. (The index basket of the present 2011-12 series has a total of **697** items including **117** items for Primary Articles, **16** items for Fuel & Power and **564** items for Manufactured Products.) The prices tracked are ex- factory price for manufactured products, mandi price for agricultural commodities and ex-mines prices for minerals. Weights given to each commodity covered in the WPI basket are based on the value of production adjusted for net imports. WPI basket does not cover services.

In India WPI is also known as the headline inflation rate.

The base year of all India WPI has been revised from 2004-05 to 2011-12 by the Office of the Economic Advisor, Department of Industrial Policy and Promotion, Ministry of Commerce, and Industry.

In India, Office of Economic Advisor (OEA), Department of Industrial Policy and Promotion, Ministry of Commerce and Industry calculates the WPI.

The main uses of WPI are the following:

- (1) To provide estimates of inflation at the wholesale transaction level for the economy. This helps in timely intervention by the Government to check inflation, in essential commodities, before the price increase spill over to retail prices.
- (2) WPI is used as deflator for many sectors of the economy including for estimating GDP by Central Statistical Organisation (CSO).
- (3) WPI is also used for indexation by users in business contracts.
- (4) Global investors also track WPI as one of the key macro indicators for their investment decisions.

Difference between Wholesale Price Index (WPI) and Consumer Price Index (CPI)

WPI reflects the change in average prices for bulk sale of commodities at the first stage of transaction while CPI reflects the average change in prices at retail level paid by the consumer.

The prices used for compilation of WPI are collected at ex-factory level for manufactured products, at ex-mine level for mineral products and mandi level for agricultural products. In contrast, retail prices applicable to consumers and collected from various markets are used to compile CPI.

The reasons for the divergence between the two indices can also be partly attributed to the difference in the weight of the food group in the two baskets. CPI Food group has a weight of 39.1 per cent as compared to the combined weight of 24.4 per cent (Food articles and Manufactured Food products) in WPI basket.

The CPI basket consists of services like housing, education, medical care, recreation etc. which are not part of WPI basket. A significant proportion of WPI item basket represents manufacturing inputs and intermediate goods like minerals, basic metals, machinery etc. whose prices are influenced by global factors, but these are not directly consumed by the households and are not part of the CPI item basket.

Thus, even significant price movements in items included in WPI basket need not necessarily translate into movements in CPI in the short run. The rise or fall in prices at wholesale level spilled over to the retail level after a lag.

Similarly, the movement in prices of non-tradable items included in the CPI basket widens the gap between WPI and CPI movements. The relative price trends of tradable vis a vis non-tradable is an important explanatory factor for divergence in the two indices in the short term.

(Source: Arthapedia)

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. The US FED promotes the stability of the financial system and seeks to minimize and contain through active monitoring and engagement in the U.S. and abroad.
 - (a) Credit risks
 - (b) unsystematic risks
 - (c) systemic risks
 - (d) Default risks
2. When the Federal Reserve conducts, it sells a security to an eligible counterparty and simultaneously agrees to buy the security back the next day.
 - (a) an Overnight Reverse Repurchase Agreement
 - (b) an Open Market Operation
 - (c) a Term Deposit
 - (d) a Moral Suasion
3. Which among the following is not true?
 - (a) WPI reflects the change in average prices for bulk sale of commodities at the first stage of transaction while CPI reflects the average change in prices at retail level paid by the consumer.
 - (b) The prices used for compilation of WPI are collected at ex-factory level for manufactured products, at ex-mine level for mineral products and mandi level for agricultural products.
 - (c) The WPI basket consists of services like housing, education, medical care, recreation etc. which are not part of CPI basket.
 - (d) The Federal Reserve System conducts the nation's monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy.

4. Under the scheme, the Government of India borrows from the RBI and issues treasury bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows.
 - (a) Liquidity Adjustment Facility
 - (b) Margin Standing Facility
 - (c) Market Stabilization Scheme
 - (d) Open Market Operations
5. The main purpose of Quantitative easing is
 - (a) controlling inflation
 - (b) controlling deflation
 - (c) controlling recession
 - (d) to stimulate economic activity

Theoretical Questions

1. What do you understand by a credit policy? Discuss the various objectives of credit policy.
2. Explain the various instruments of credit policy.
3. Write a short note on the Consumer Price Index and the various issues relating to it.
4. Discuss Wholesale Price Index and differentiate it from Consumer Price Index.

ANSWERS/SOLUTIONS

Answer to Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(c)	5.	(d)
----	-----	----	-----	----	-----	----	-----	----	-----

Answers to the Theoretical Questions

1. Please refer to paragraph 1.2
2. Please refer to paragraph 1.5
3. Please refer to paragraph 4
4. Please refer to paragraph 5