Finance Basics –Monetary Policy and Inflation

Monetary Policy

Monetary policy refers to the monetary authority's intentions about money supply, interest rates, and exchange rates. Usually, the monetary authority is the Central Bank, like the Reserve Bank of India (RBI). Broadly speaking monetary policy regulates money supply and related nominal variables, such as the interest rate and exchange rates. The larger picture would envisage taking care of Govt finances, international borrowings, finances of commercial banks etc. as this would also affect the money supply, interest and exchange rates.

The most widely recognized role of monetary policy is the management of money supply. In India, the RBI fixes targets for the rate of growth of money supply in the economy, by fixing levels for various policy tools like the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratios (SLR) for commercial banks, and by advising the government on the monetization of its deficits. If the Bank feels that the economy can do with more money (either for investment purposes or for making daily transactions), it will follow an easy-money policy, whereby the interest rate on borrowing will come down, making cash via demand deposits more easily available to potential users. If on the other hand the Bank believes that the level of liquidity is too high, and that inflationary pressures from there being excess cash in the system is posing a threat, it will tighten the terms at which cash is available, by raising CRR, raising SLR, asking banks to raise interest rates, or a combination of policy tools.

Monetary policy, like fiscal policy, can be pro-cyclical or anti-cyclical. In times when liquidity is already easy, inflation is rising, and interest rates are low, if the bank cuts bank rates even further, this would be a pro-cyclical policy that would exacerbate the existing condition. If on the other hand, it tightens money and chokes off excess liquidity, it would be termed as an anti-cyclical policy. Suppose investments are flagging in the economy, then if the RBI eases the supply of money, it would be a countercyclical policy, as opposed to a tight-money policy, which would be pro-cyclical.

The Monetary Policy has not only to be forward looking, but it also has to grapple with an uncertain future. Additional complexities are likely to arise in case of an emerging market like India, which is transiting from a relatively closed to a progressively open economy. In an environment of increasing capital inflows, narrowing cross-border interest rate differentials (eg. Fed rates vis a vis Indian G-Sec rates) and surplus liquidity conditions, exchange rate movement tend to have linkages with interest rate movements. The challenge of the RBI is to balance the various choices into a coherent whole and to formulate a policy that can best facilitate the country's economic objectives.

Inflation

Inflation is the rate at which prices rise. Basically, prices go up for two factors: cost push and demand pull. The former occurs due to an increase in the cost of production of an item, which gets translated into a higher price for that item. The latter takes place when there is too much money with customers compared to the amount of goods available in the market. In such a situation, we have too much money chasing too few goods and prices rise because people are willing to pay more for the same item. When the item being chased is in short supply, we have demand pull inflation.

In India, we have a combination of both cost push and demand pull. For instance, the high growth in onion prices was an instance of demand pull inflation, when the shortage of onions in the market took the prices to new heights. Also, prices go up whenever there is a hike in prices of petroleum products. Inflation or price rise here is due to cost push factors. This is because petroleum is a vital input in many manufactured items and as an essential fuel for road transport, it adds to the transportation costs and so prices in general tend to rise.

The Inflation Conundrum

Often, in real life situations, we find that we feel the pinch of inflation even though prices rise only by 2-3%.While the inflation figures that the government publishes every week are rates of change in wholesale price index (WPI), representing the rate of increase in the wholesale prices of products, what matters to us as individual buyers is the consumer price. Though prices in the wholesale market have grown at a slow pace (at about 2-3 per cent), comparatively, consumer prices (measured in terms of consumer price index - CPI) have grown at a much faster pace (about 8-9 per cent). Hence this situation.

Source: ET, Mankiw and my own understanding of economics

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