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"Monetary Policy 2022-23: Its focus on dealing with Current Inflation in the Indian Economy"

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Abstract

Inflation expectations are closely monitored by central banks. However, in most models, inflation expectations are bound by the premise of rational expectations, thus they should be of little concern to policymakers on their own. In this paper, we examine the influence of inflation expectations on the economy and monetary policy action by relaxing the premise of rational expectations with perfect information. Endogenous inflation scares, or severe and persistent departures in inflation expectations from those predicted by rational expectations can arise as a result of learning disturbances.

According to empirical studies, the existence of learning makes inflation expectations and interest rate term structures more sensitive to economic shocks. In an ideal world, inflation expectations are found to be a straight line or nearly straight line with a combination of macroeconomic characteristics that provide no additional information to policymakers. Inflation expectations are subject to learning and follow a time-bound process, providing important procedure in formulating monetary policy.

Keywords*: Inflation forecasts, Policy rules, rational expectations, monetary policy*

Introduction

The Reserve Bank of India (RBI) used to frame, implement and regulate the monetary policy in India. The role of RBI is defined under the Act of 1934. In India, the prime function of the RBI is to foster economic development while maintaining price stability, as well as to provide an adequate institutional framework to support this process. Monetary policy has influenced the cost, volume, and direction of credit, promoted sectoral and overall development and supported social justice programs. The basic goal of the money supply may be described as the regulated increase of bank credit, with specific emphasis paid to seasonal credit requirements.

The major goal of monetary policy has been to keep inflationary forces at bay without jeopardizing economic potential. The objective of monetary policy is to promote the financial system's efficiency and to effect suitable structural change. Interest rates have been deregulated, operational limitations in the credit delivery system have been eased, and new money market instruments have been introduced. Monetary policy aims to remove complexity, provide flexibility, encourage diversification, foster a more competitive environment, and instill greater discipline and prudence in the financial system's operations.

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Monetary measures to control inflation

Monetary intervention is aimed at reducing revenue from money-

1) **Credit management:** Monetary policy is one of the most important monetary interventions. In order to regulate the quantity and quality of credit system the central bank use to adopt various measures. In order to achieve the aforesaid objective, the bank interest rates are raised depending upon the Inflation, securities are also sold in the open market in order to achieve reserve ratio. In addition to it a variety of selective credit measures are being taken such as rising marginal threshold and limiting consumer lending which are implemented depending upon the market situation. When monetary policies become ineffective in controlling inflation the above measures were taken by the central bank so as to make the economy stable.

2) **Currency demonetization**: When there is excess of black money in terms of cash currency demonetization steps are taken by RBI. The demonetization uses to invalidate currency of higher denomination which is one of the major steps to revive the economy from the trap of black money.

3) **New currency issues**: The issue of replacing old cash with the new currency is one of the drastic steps used to be taken by RBI to check inflation and regulate the monetary policy. In this process the supply of excess currency is being checked and the inflation use to be checked. This measure is being implemented when issuance of note is excessive which resulted to hyperinflation. However, this do have a great impact on the small depositor as the value of the bank deposit is being determined depending upon the inflation. (ACMC, 2022)[1]

The method used under the monetary policy to control inflation

Monetary policy is implemented using a variety of direct and indirect instruments. They are-

- **Repo Rate:** The bank is being provided liquidity against the collateral security of the government and other approved asset at a fixed rate of interest. This is known as liquidity adjustment facility as has been provided by RBI.

- **Reverse Repo Rate:** Under the liquidity adjustment facility the RBI absorbs liquidity from bank in exchange for qualified government security which was held as collateral security.

[1] ACMC, E., 2022. *Causes Of Inflation and Measures to Control It - Bscholarly*. [online] Bscholarly. Available at: <https://bscholarly.com/causes-of-inflation-and-measures-to-control-it/> [Accessed 26 April 2022].

- **Liquidity Adjustment Facility (LAF):** The RBI use to determine the repo rate by gradually raising the liquidity facility through variable rep rate with variation of tenure. The term repo goal facilitates the development of inter-banking the money market which create market-based target for the rising of loan and deposit which helps in improvement of monetary policy depending upon the market condition.

- **Marginal Standing Facility (MSF):** The commercial banks in order to reduce the statutory liquidity ratio portfolio use to borrow money from the RBI up to a particular limit and use to pay penal rate of interest. This acts as a protection of financial system against the unanticipated liquidity stocks.

- **Corridor:** Each day fluctuation in the market affects the money exchange rate as a result of which the same is being determined by the marginal standing facility rate and the reverse repo rate.

- **Bank Rate:** The repo rate is otherwise known as the marginal standing facility rate whereby the RBI adjust the bank rate of interest which is the rate of interest of MSF. Therefore, the rate of interest is being automatically adjusted which helps in avoiding unanticipated liquidity.

- **Cash Reserve Ratio (CRR):** The reserve bank use to notify in the gadget of India from time to time the cash reserve ratio to be maintained by the commercial banks in order to achieve this same the RBI use to determine the percentage of its net demand and time liabilities which a bank is required to maintain with RBI as average daily balance. This is known as cash reserve ratio.

- **Statutory Liquidity Ratio (SLR):** It implies that a bank is required to keep in shape and liquid asset like unencumbered government securities cash and goal as per the NDTL norm. Further statutory liquidity ratio has a significant impact on the banking system in order to lend the private sector.

- **Open Market Operations (OMOs):** The bank for the purpose of injecting and absorbing long term liquidity use to purchase and sale the government asset.

- **Market Stabilization Scheme (MSS):** In order to achieve market stability in the year 2004 the RBI have evolved monetary management tool in 2004. As per the said scheme the short-dated government securities and treasury bill are sold to accommodate surplus liquidity of a long-term nature which use to create big capital inflows. In the process the money which has been mobilized was kept in a

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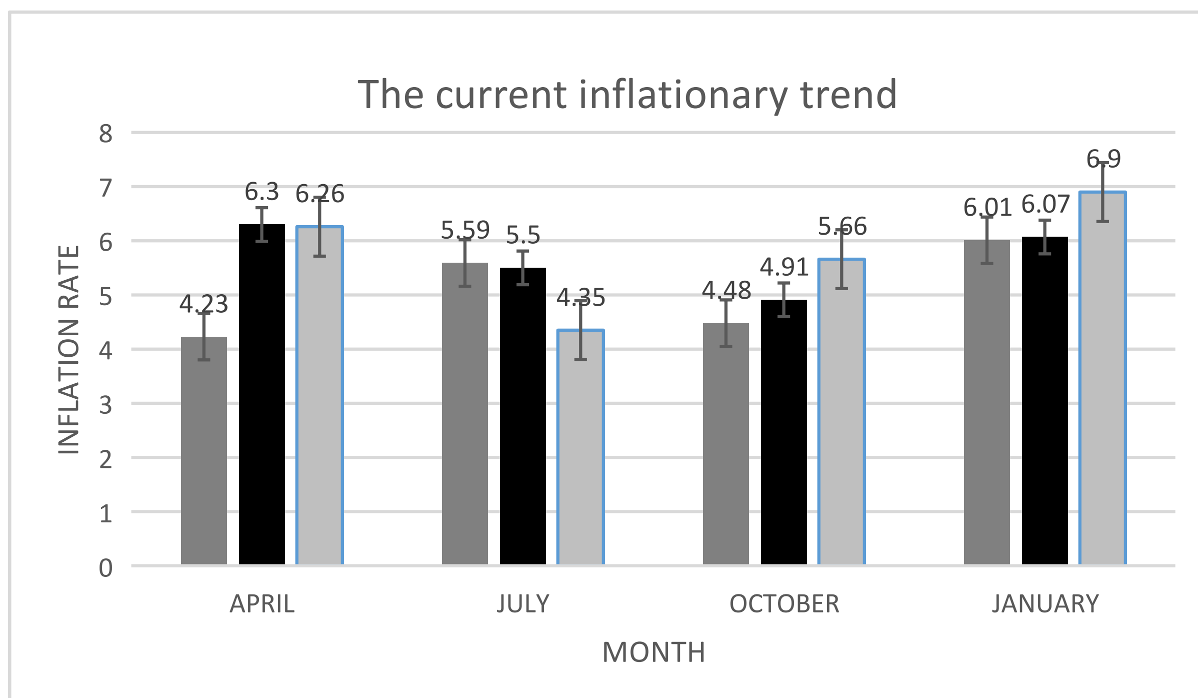
independent government account in the RBI. (Reserve Bank of India - Function Wise Monetary, 2022)[2]

The current inflationary trend



INFORMATION SOURCE: Ministry of Statistics and Programme Implementation (MOSPI)

Information Table:1

Calendar	GMT	Reference	Actual	Previous	Consensus	Forecast
2022-03-14	*12:00 PM*	*Feb*	*6.07%*	*6.01%*	*5.93%*	*5.9%*
2022-04-12	*12:00 PM*	*Mar*	*6.95%*	*6.07%*	*6.35%*	*6.3%*
2022-05-12	*12:00 PM*	*Apr*		*6.95%*		*7.4%*

[2] Rbi.org.in. 2022. *Reserve Bank of India - Function Wise Monetary*. [online] Available at: <https://www.rbi.org.in/scripts/FS_Overview.aspx?fn=2752> [Accessed 25 April 2022].

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Information Table:2

Related	Last	Previous	Unit	Reference
Inflation Rate	*6.95*	*6.07*	*percent*	*Mar 2022*
Consumer Price Index CPI	*167.70*	*166.10*	*points*	*Mar 2022*
GDP Deflator	*160.10*	*146.10*	*points*	*Dec 2022*
Food Inflation	*7.68*	*5.85*	*percent*	*Mar 2022*
CPI Transportation	*157.90*	*156.90*	*points*	*Mar 2022*
Inflation Rate Mom	*0.96*	*0.24*	*percent*	*Mar 2022*
CPI Housing Utilities	*165.30*	*165.50*	*points*	*Mar 2022*

In March 2022, India's annual inflation rate reached 6.95 per cent, the highest since October 2020. For the sixth month in a row, food inflation increased to 7.68 per cent, a new high since November 2020, with the cost of oil, fats, vegetables, meats and fish raising the most. Other sources of rising pressure included clothes, footwear, fuel, light, housing, pan and tobacco. For the third month in a row, inflation remained above the central bank's tolerance ceiling of 2% to 6%, although the full impact of crude oil price increases will not be seen until April, as the government has postponed the pass-through of energy prices to consumers.

Growth and inflation projections by ADB

The Asian Development Bank (ADB) predicts that India's GDP growth will slow to 7.5 per cent in 2022-23, down from a projected 8.9 per cent in 2021-22, but then accelerate to over 8% next year.

The ADB has taken into account the implications of *the Russia-Ukraine conflict for India*, which will be mainly mitigated by increasing oil prices, and has estimated that the severity of the *COVID-19* pandemic will decrease as vaccination rates rise. Although rising oil prices will keep inflation pressures high, the impact will be mitigated by fuel subsidies. With an average inflation rate of *5.8% in 2022-23* and *5% in 2023-24*, according to the ADB, consumer prices will continue to rise, with oil prices predicted to average over *$100 per barrel through 2022-23.*

A key challenge

Due to the hike in oil prices throughout the globe, inflation would exacerbate the current account deficit. It is reported that identifying domestic resource mobilization is a critical problem for every sphere of the government, as India's tax-to-GDP ratio of around *17%* has remained basically stable since early 1990.

The state government had been passing through difficult time while mobilizing resources, and strengthening its budgetary resources which were crucial for India's long-term and inclusive prosperity.

This is significant to note here the state fiscal deficits have been rising *since 2011-12*, and the state debt-to-GDP ratio has been raising since 2015-16. In 2020-21, India's general government debt, a third of which was accounted for by the state, was predicted to remain high, at about 90% of GDP. (Paper et al., 2022)[3]

India's budgetary growth raises fears about inflation and interest rates tightening

On the basis of record market borrowing, India's growth-focused budget for the 2018 fiscal year has fanned fears among bond dealers that the central bank may be obliged to act on rising inflation despite its dovish policy stance.

India proposed a capital expenditure budget of 7.5 trillion rupees for the fiscal year 2022-23, representing 2.9 per cent of GDP and a 35.4 per cent increase over the previous fiscal year. The government is reportedly said to have borrowed a record 14.95 trillion rupees, much above market expectations of 12 to 13 trillion rupees.

Since May 2020, India's central bank has kept its repo rate at a record low of 4% and told the market that it will keep its policy stance accommodative till the economy is solidly established.

As a countermeasure to the expansionary budget, the RBI could have reconsidered its lenient attitude. The market will lose faith in the RBI's ability to regulate inflation if inflation continues for longer time. In the absence of open market operations, economists expect the benchmark bond yield, which has climbed approximately 45 basis points in 2022 after rising 55 basis points last year, would likely continue to rise in the near term. In the fiscal year 2023, the reverse repo rate is expected to be hiked by a total of 90 basis points at the policy review meeting.

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[3] Paper, T., Editor, R., Page, O., 2022, B., Quotes, S., Sports, O., gardens, H. and 7.5%, A., 2022. *ADB pegs 2022-23 GDP growth at 7.5%.* [online] Thehindu.com. Available at: <https://www.thehindu.com/business/Economy/adb-pegs-2022-23-gdp-growth-at-75/article65295702.ece> [Accessed 25 April 2022].

In the fiscal year 2023, the RBI will have to start raising its policy rate, and it is estimated at least an increase of 100 basis point.

<u>Inflation control policy of the RBI for 2022-23</u>

In order to combat the pandemic-related depression and inflation, the monetary policy committee met on April 6th, 7th, and 8th, 2022 had agreed unanimously to maintain the policy *repo rate at 4%.* The monetary policy committee (MPC) also unanimously determined to keep policy accommodating while focused on removing it in order to keep inflation within target while supporting growth. The MSF (marginal standing facility) rate and the bank rate both continue at 4.25 per cent and the Reserve Bank of India has chosen to restore the width of the liquidity adjustment facility corridor to 50 basis points, as it was before the pandemic. The newly established standing deposit facility, which will be *25 basis points* below the repo rate *of 3.75 per cent*, will now supply the corridor's floor.

The predicted positive outcome from the omicron wave had been disturbed dramatic due to spike in geopolitical tension since the MPCs last meeting in early February 2022. The price of crude oil, as well as metals and other commodities, has risen dramatically globally. The level of aversion to developing market assets has risen, resulting in substantial capital outflows and a depreciation bias in their currencies. This development has accelerated worldwide inflation projections, which were already considerably above target in most nations and would have a significant negative impact on outputs across economies.

The RBI Act was amended in 2018 to empower the Reserve Bank of India to introduce SDF (Standing Deposit Facility) by removing the central bank's binding collateral constraint, thereby strengthening the monetary policy operating framework. As a result, it has now been decided to introduce SDF and LAF (Liquidity adjustment facility) and the banks will be able to assess SDF and MSF at their discretion, such as repo rate, reverse repo rate, OMO, and CRR.

During this period the SDF rate will be *25 basis points below the* policy rate and will only apply to overnight deposits, while the MSF rate will remain *25 basis points above the* policy repo rate. As a result, the LAF corridor's width is returned to 50 BPS, symmetrically around the policy repo rate, which will be at the center of the corridor, as it was before the pandemic.

The 3.35 per cent fixed reverse repo rate will be maintained as part of the RBI's toolset, and its operation will be at the RBI's discretion. The FRR, in conjunction with the SDF and will give the RBI to handle the liquidity management framework more flexibly. With effect from April 19, 2022, it has also been decided to restore the pre-pandemic opening time for the financial markets regulated by RBI to 9 a.m., without affecting the current closing time.

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Conclusion

Covid-19 has wreaked havoc on economies all over the world. This resulted in a severe downturn in several industries across the globe and has put a severe impact on the economy. Despite worldwide governmental assistance, the pandemic is expected to have a 5.2 per cent negative impact on the global economy. Monetary policy measures lessen the pandemic's short-term impact on the economy, and they can surely aid the economy's recovery once all restrictions are lifted. Because interest rates influence economic policy and decisions, the central bank's information regarding future rates is a key medium via which monetary policy influences the macro economy.

Such an effect demonstrates that the central bank may regulate aggregate demand by stating that the interest rate will remain low for an extended period of time when the policy rate cannot be lowered.

According to academic research, quantitative easing under the unconventional monetary policy is projected to increase inflation pressure in the economy. Monetary policy has the potential to mitigate the pandemic's harmful effects by boosting consumption and investment patterns and bringing the economy back to its shape.

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