

SEM 2: HONS: MACRO

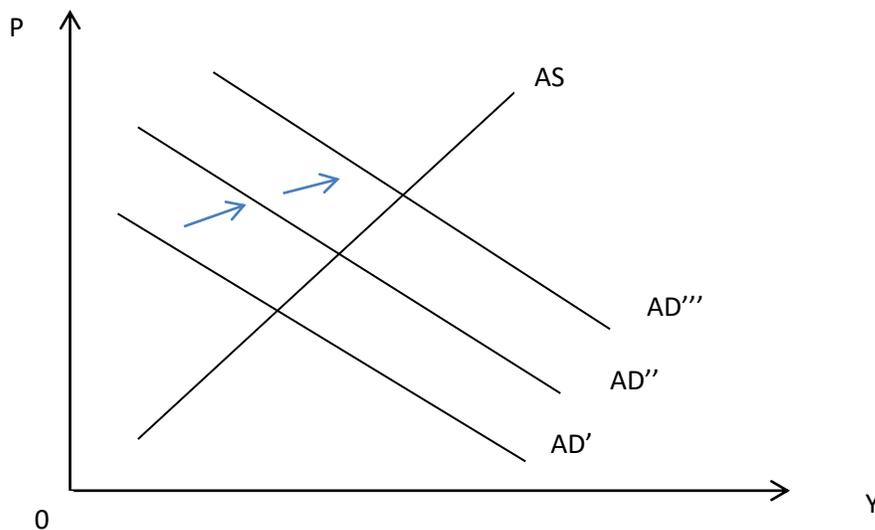
INFLATION

Topic: Causes of Inflation

The major explanations of inflation are broadly classified into (i) demand pull factors and (ii) Cost push factors. Both can be explained using shifts in the AD-AS curves.

Demand Pull Inflation

Consider any factor that causes a shift in AD to the right (say there is an increase in C, I, G or M). With upward sloping AS curve, both P and Y will increase. Now a one time increase in P is not inflationary unless the rise in P is sustained. When government continues to raise G period after period causing continuous rightward shift in AD and finance it continuously through money creation inflationary situation is created. The inflationary impact of deficit financing depends on the slope of the AS curve. If AS is flat (as it is likely to be in the short-run with excess capacity) then the impact will be zero on P. Only Y is stimulated. When AS becomes steeper, the impact on P becomes more and more pronounced. In the long-run, when AS is vertical with fully flexible w and P, budget deficit is 100 percent inflationary.



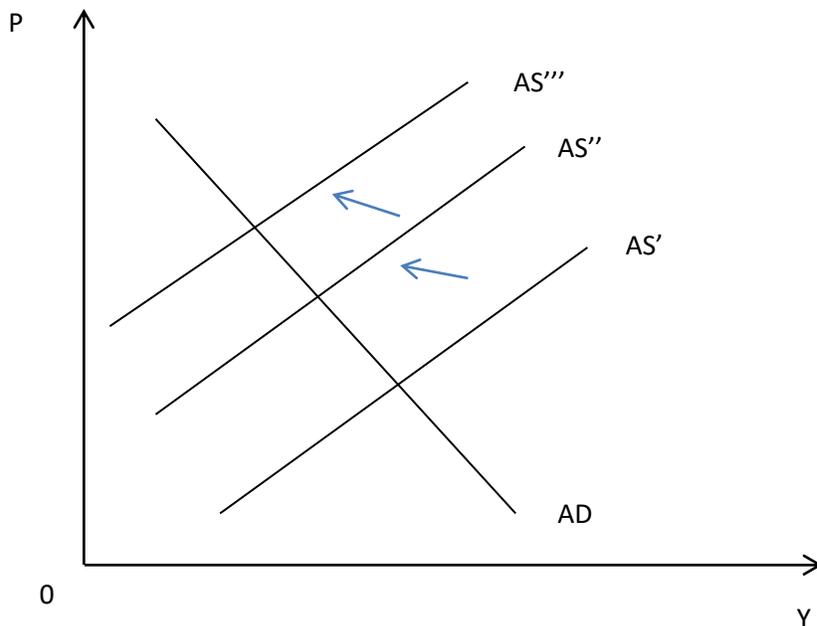
Demand-Pull Inflation

Cost Push Inflation

Suppose money wage w rises. This makes AS curve to shift to the left. With AD unchanged, the effect is to raise P . Once again, for the change to be inflationary, w must keep rising to higher and higher levels. Let us see how wage spiral works. An initial rise in w increases the real wage, w/P . As P rises, however, the gain is eroded and real wage tends to fall back to its initial value. After realizing the fall in real wage, workers demand another hike in w . This causes P to rise further which again provokes the demand for another pay revision and so on. Thus the wage-price spiral leads to sustained inflation.

The same effect could have been obtained due to adverse supply shocks, i.e., increase in price of any material input.

It is to be noted that the behaviour of output may help one to identify the source of inflation because, in demand pull inflation Y raises along with P but in cost push, Y falls as P rises.



Cost-Push Inflation

Anti-Inflationary Policies

Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.

Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.