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Managing Inflation: Central Bank's Blueprint for Economic Stability

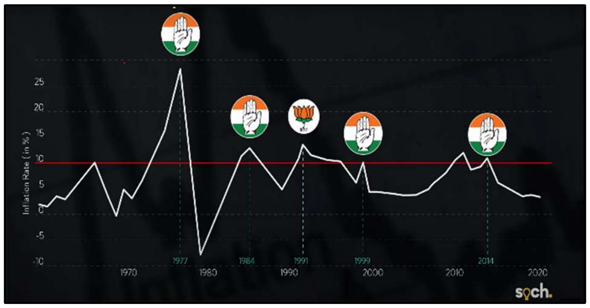
Knowledge Series

September 2024

Volume 6 (Series 6)

❖ Introduction

Inflation might seem a monotonous topic at first but let us make it more interesting. Look at the following graph. It will help you gain a better understanding regarding importance of inflation in economic as well as political stability of a country. This will spark your interest in the subject.



This graph clearly indicates that whenever inflation in India exceeds 10%, there tends to be a change in the ruling party.

❖ Meaning of Inflation?

Inflation is gradual loss of purchasing power of money that is reflected in a significant rise in prices for goods and services over time. In a nutshell, increase in price of goods & services which leads to decrease in purchasing power of money is inflation.

For example, price of onion in the market was Rs. 15/- per KG in 2020. The price of same quality of onion is Rs. 20/- per KG in 2024. Therefore, inflation rate for the period 2020 to period 2024 is 33.33%.

❖ Factors causing Inflation

Inflation is mainly caused by the following three factors:

1. **Demand Pull Factors:** Demand for the goods or services increases but supply remains the same or decreases.

2. **Cost Pull Factors:** When the price of goods or services increase due to an increase in production cost i.e. increase in cost of inputs required to produce a particular good or service.

3. **Built-In Inflation:** It results from a cycle of rises of wages and prices, often fueled by inflation expectations. Workers demand higher wages to keep up with rising living costs, which in turn leads businesses to increase prices, creating a feedback loop.

❖ How is Inflation calculated?

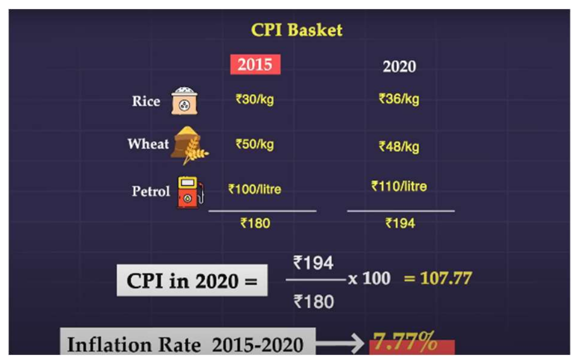
Having established a clear understanding of inflation and its underlying causes, we can now address a critical question: How is inflation calculated? Primarily, there are two key methods used to measure inflation, which are as follows

1. Consumer Price Index *(CPI)*

- It is the primary index that tracks the changes in retail prices of essential goods and services consumed by Indian households.

- The index assigns different weights to various goods and services in the basket and tracks the movement of their prices. It also tracks the price movement of the entire basket on a pan-India basis to calculate the overall inflation figure or CPI inflation.

- Currently, prices of 299 essential Goods & Services from 8 different categories are considered for the calculation of inflation. Prices from 1,181 Rural markets and 1,114 urban markets are considered.



Using the CPI, we can interpret following four economic indicators of country:

- Cost of living and how it is increases
- Purchasing power of consumers
- Expensiveness of different goods and services
- Value of currency and change in value of Currency

2. Wholesale Price Index *(WPI)*

- While retail inflation looks at the price at which the consumer buys the product, WPI is measured based on prices at the wholesale level.

- There are two layers between the wholesale price and retail price, one is the additional cost of transportation from the wholesale to the point of sale, and the other is the retail mark-up.

CPI = WPI + Cost of Transport till POS[1] + Retail Mark-up

- Another difference between the two indices is that the wholesale market is only for goods, you cannot buy services on a wholesale basis. So, WPI does not include services, whereas the retail price index does.

❖ How Central Bank Manages the impact of Inflation to achieve economic stability:

As it is commonly said that, "*Price stability is not just about keeping inflation low; it's about maintaining the confidence of the people in the value of their money.*" So, let us understand in detail what are the techniques or trades used by central bank to manage the inflation:

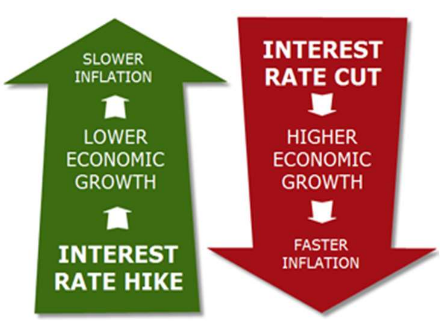
1. **Interest Rate Adjustments:**

To curb the inflation rate in India, one of the most important tools that RBI uses is Repo Rate.

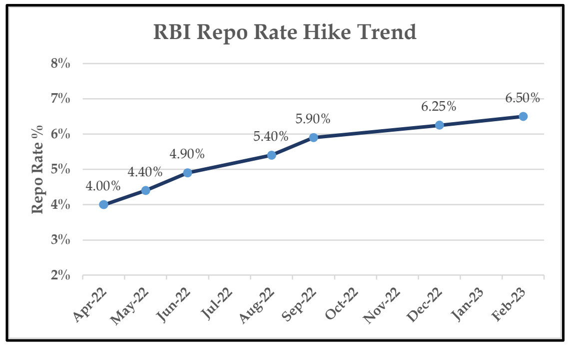
To put it simply, Repo rate is an interest rate at which RBI lends money to commercial banks. These commercial banks further lend the money to ultimate consumers.

Since Inflation in India was on rise since past 5-6 years due to Covid and the Russia-Ukraine war, RBI has followed a trend to hike the Repo Rates.

So, interest rate hikes have inverse relationship with the Inflation. Increase in Repo Rate leads to increase in interest rate for Floating Rate Loans which causes to increase in EMI for individuals or corporates, ultimately resulting in the decreased purchasing power of individuals.



Ever since the Russia-Ukraine war started Indian central bank has continuously increased the interest rates in the effort to control the inflation.



To understand it more clearly, let's understand it through an example:

Mr. Joshi has taken a loan worth Rs. 30 Lacs for the tenure of 20 years and he draws a monthly salary of 80K. Considering that his Interest Rate went from 7% in Jan 2022 to 9.25% in April 2024. Consequently, his EMI will also rise from Rs. 23,258/- to Rs. 27,387/-, an increase by 17.75%.

Assuming earlier Mr. Joshi had effective saving of Rs. 15,000/- after the payment of monthly loan instalments. However, now he will only save Rs. 10,871/- This indicates that his purchase power will be decreased by Rs. 4,129 per month which amounts to a decrease of Rs. 49,548/- annually.

2. **Open Market Operations *(OMS)***

Through OMOs, central banks buy or sell government securities in open market to control the money supply. By selling securities, they can reduce the amount of money in circulation, thus reducing inflationary pressure. Whereas, buying securities injects money into the economy, stimulating growth. The European Central Bank (ECB) has used OMOs extensively, especially during the Eurozone crisis, to stabilize inflation and support economic recovery.

3. **Reserve Requirements**

Central banks can alter the reserve requirement ratio, which is the amount of money banks must hold in reserve and cannot lend out. Increasing the reserve ratio reduces the money available for lending, which helps in controlling inflation. For instance, a sudden increase in reserve requirements can lead to a sharp contraction in bank lending, potentially causing liquidity problems or even triggering a financial crisis. However, this tool is less commonly used in modern economies compared to interest rate adjustments and OMOs.

❖ Global Perspective for Inflation Management

Central banks across the globe face unique challenges when managing inflation, depending on their economic structures, political environments, and historical experiences.

1. **United States:** The Federal Reserve has a dual mandate to promote maximum employment and stable prices. During the COVID-19 pandemic, the Fed slashed interest rates to near zero and launched an unprecedented bond-buying programme to support the economy. However, as inflation surged in 2021-2022 due to supply chain disruptions and stimulus-fuelled demand, the Fed had to pivot quickly, raising rates to prevent the economy from overheating.
2. **Eurozone:** The European Central Bank (ECB) oversees a diverse set of economies with varying inflation rates. The ECB's primary mandate is price stability, but the challenges of a shared currency and divergent fiscal policies among member states make inflation management complex. For instance, during the Eurozone debt crisis, the ECB had to balance the deflationary pressures in southern Europe with inflationary concerns in the north.
3. **Japan:** The Bank of Japan has struggled with deflation for decades. Despite aggressive monetary easing and negative interest rates, inflation remains stubbornly low. The BoJ's experience highlights the challenges of reversing entrenched deflationary expectations, which can be as damaging as high inflation.
4. **Emerging Markets:** Central banks in emerging markets often face the dual challenge of controlling inflation while supporting growth. For example, Turkey's central bank has grappled with high inflation due to political interference in monetary policy, leading to currency depreciation and economic instability. In contrast, Brazil's central bank has taken a more independent stance, raising rates pre-emptively to tackle inflation and maintain market confidence.

❖ The Trade Offs: Growth vs Inflation

Managing inflation is a balancing act. Tightening monetary policy to combat inflation can slow economic growth and increase unemployment, while overly accommodative policies can lead to runaway inflation. Central banks must carefully assess the trade-offs and consider the broader economic context when setting policy. To put it simply, "In the battle against inflation, the cost of inaction is often higher than the price of decisive intervention."

❖ The Roadmap Ahead: Adapting to New Challenges

As the global economy evolves, central banks must adapt strategies to manage inflation effectively. Emerging risks such as climate change, geopolitical tensions and technological disruptions could impact inflation dynamics, requiring innovative approaches.

For instance, climate change could lead to more frequent supply shocks, complicating inflation management. Similarly, technological advances like digital currencies may alter the transmission of monetary policy, necessitating new tools and frameworks.

"In an ever-changing world, the only constant is the central bank's commitment to maintain the value of money."

❖ Conclusion: The Blueprint for Stability

Central banks play an indispensable role in safeguarding economic stability by managing inflation. Through a combination of traditional tools, strategic frameworks, and effective communication, they navigate the complex landscape of modern economies. However, the challenges are ever evolving, and central banks must remain vigilant and adaptable to maintain their credibility and effectiveness. In a world where economic shocks are frequent, the blueprint for managing inflation is not static but a living document, constantly revised to meet new challenges. The ability of central banks to maintain price stability while supporting economic growth will determine the prosperity of nations in the years.

Please note that the information presented in this Knowledge Series is derived from publicly available sources, and most of the tools mentioned have not been utilized. This Knowledge Series is intended solely for informational purposes and does not serve as an endorsement or promotion of any of the tools listed.

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❖ Special Mention:

Thank you, **Kiran Chavan**, for successful compilation of this Knowledge Series.

❖ Compliance Calendar for the month of September 2024

S. N.	Due Date	Compliance
1	07 September	Payment of TDS/TCS (Monthly)
2	07 September	Payment of Equalization Levy
3	07 September	ECB-2 Return
4	11 September	GSTR-1 (Monthly)
5	13 September	B2B Invoice Reporting through IFF (QRMP Scheme)
6	13 September	GSTR-6 (ISD Return)
7	15 September	Payment of ESIC and Return
8	15 September	Payment of PF and Return
9	15 September	Payment of Advance Tax (for Q2 of FY 2024-25)
10	20 September	GSTR-3B (Monthly)
11	25 September	GSTR-3B (Payment under QRMP)
12	30 September	Monthly Return of PTRC
13	30 September	AOC-4 Financial Statements
14	30 September	DIR 3 or KYC verification of DIN holders for financial year
15	30 September	Annual General Meeting
16	30 September	Audit report in Form no. 10B/10BB by a fund or trust
17	30 September	Filling of Tax Audit Report (except Transfer Pricing cases)

❖ GC CORNER:

After the tax season, on 24th August, Team RRCo organized a one-day tour to Prathmesh Resort for some relaxation and adventures.

In August month, 2 of our articles presented paper in National Conference of CA Students held at Pune.