



## **THE ROLE OF CENTRAL BANK IN CONTROLLING INFLATION POST COVID-19: A STUDY OF INDIA AND THE UNITED STATES**

Paper by:-

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### **Abstract**

The paper aims to study the role of the Reserve Bank of India (RBI) and the Federal Reserve (Fed) in India and the United States (US) respectively in controlling the inflation post COVID-19 (simply referred to as COVID hereafter). It examines the steps taken by RBI from January 2022 to December 2023 while those of the Fed from March 2021 to December 2023. For official sources, the paper primarily relies on the Monetary Policy Statements issued by the Monetary Policy Committee (MPC) in India and the Federal Open Market Committee (FOMC) in the US. The surge in inflation in both India and the US was a product of high food and fuel prices, supply chain disruptions, pent-up demand and geopolitical tensions and sanctions. While both RBI and FOMC relied on raising their respective policy rates to curb inflation, differences emerged in the pace and intensity of their approaches, as well as their use of Open Market Operations. The paper first studies the case of India followed by that of the US and then presents a comparative analysis of the two.

### **Introduction**

With the outbreak of COVID and its declaration as ‘pandemic’ by World Health Organization (WHO) on 11<sup>th</sup> March, 2020, many countries imposed nation-wide lockdowns which led to closure of the economies across sectors leading to severe disruptions in the global supply chain marked by persistent inflationary pressure. The central bank is primarily responsible for keeping inflation at its target in order to maintain price stability while supporting economic growth.



Recently—particularly since 1991—many modern economies have shifted to directly target inflation rate (as against targeting money supply growth pre-1991) by keeping it within a defined range in the long-run while allowing short-run fluctuations. The major instrument used for this purpose is the Policy Interest Rate.

In India, the MPC uses the Policy Repo Rate to keep inflation rate (according to headline Consumer Price Index) at 4% with  $\pm 2\%$  tolerance band (Ministry of Finance, Government of India), while in US the FOMC uses the Federal Funds Rate to keep the inflation at 2% (according to Public Consumption Expenditures Index) along with ensuring maximum employment (Federal Reserve). During the COVID-19 period, both India and the United States experienced significant deviations of inflation from their respective target levels. In response, the central banks of both countries implemented a series of monetary policy measures aimed at restoring price stability.

This paper seeks to examine and compare the policy actions undertaken by the RBI and the Fed in the post-pandemic period. A comparative analysis of their approaches will not only enhance our understanding of inflation-targeting frameworks in different economic contexts but also provide insights for shaping future policy responses to similar macroeconomic shocks.

## Literature Review

In order to understand the ever-evolving nature on inflation, especially during COVID and consequently, the responses undertaken by the central banks in order to curb it, a few of the relevant research papers have been referred by the author.

Pami Dua (2020) has written in her paper “Monetary policy framework in India”, about the adoption of Flexible Inflation Targeting (FIT) framework in 2016. She explains how an increase in the policy rate affects the aggregate demand through the interest channel. An increase in policy rate corresponds to a rise in Weighted Average Call Money Rate (WACR). This leads to rise in other short-term and long-term interest rates, thereby influencing the aggregate demand.



This forms the basis of the monetary policy transmission mechanism that helped in analysing the interventions made by the RBI and the Fed in their respective countries to curb the inflation.

In the “Ball, Leigh & Mishra (2022)”, the authors decomposed the US inflation into core and non-core components to study the forces that contributed to the rise in the individual components. Their paper found three major drivers of core inflation: (i) long-term expected inflation, (ii) labour market tightness measured through the vacancy-to-unemployment ratio (V/U) and (iii) pass-through effects from headline shocks. The major breakdowns of headline shocks were: (i) surge in energy prices (ii) supply chain disruptions and (iii) spike in automobile prices. Their paper also highlighted a key policy insight. Additionally, the American Rescue Plan (ARP) also led to the inflationary pressure by raising aggregate demand and tightening the labour market. While their paper is confined to the US economy, it nevertheless provides a decomposition of COVID inflation and provides a framework for understanding how temporary sectoral shocks can have persistent macroeconomic consequences, and how policy design must take into account both demand and supply side dynamics in a post-pandemic economy.

In his recent working paper, Richard H. Clarida (2025) has examined the global inflation surge in 2021-22, and the subsequent deflation process. He has found out three primary causes for the surge in inflation: “supply shocks from pandemic disruptions and Russia’s invasion of Ukraine, accommodative fiscal and monetary policies that responded to the economic dislocation caused by pandemic, and a demand shift toward goods relative to services, that exacerbated supply chain pressures.” Clarida highlights that the Advanced Economies (AEs) were initially slow to react to this surge, however succeeded by following an aggressive approach along with easing of supply constraints. Furthermore, Clarida’s paper examines possible changes in Forward Guidance. He also discusses the role of Scenario Analysis in improving the communication from the central bank’s side.



While several papers have independently examined the surge in inflation and the central bank's response in either India or the US, there remains a gap where both India and US are presented with a comparative analysis through a single lens. This paper seeks to bridge that gap and serve as a reference for future relevant studies by examining Indian and US economy side-by-side.

## **Methodology**

This paper has adopted a descriptive, theoretical approach to study the role of RBI in India and the Fed in the US to control the inflation post-COVID period. Rather than conducting an econometric analysis, the paper has focused on secondary, official data and peer-reviewed literature. The analysis is focused during 2022-2023 for India and 2021-2023 for the US, which captures the surge in inflation as well as the policy responses undertaken during the recovery. The paper has relied on official monetary statements of the Monetary Policy Committee (MPC) in India and the Federal Open Market Committee (FOMC) in the US, while also referring to other academic works and working papers. The macroeconomic data has been referred from RBI Database on Indian Economy (DBIE), Federal Reserve Economic Data (FRED) and U.S. Bureau of Economic Analysis. The paper has also adopted an analytical approach by presenting a comparative analysis of the responses of the MPC and the FOMC.

## **Findings and Analysis**

### **INDIA**

The rise in inflation in India was a result of two black-swan events of COVID-19 and the geopolitical crisis in Europe which revealed certain distinct contours in the central bank's approach in those turbulent times (Das 2022). The primary aim of the RBI and the MPC was to safeguard the economy and preserve financial stability. Pre-2022, the emergence of Omicron variant had dampened global demand. The supply chain disruptions and the protectionist policies adopted by major economies further aggravated the inflationary pressures.



The early signs of inflation were visible in February 2022 when inflation crossed the upper tolerance band of 6% and reached 6.1% (Reserve Bank of India 2022b). The escalation of geopolitical tensions increased the inflationary pressures. The global economic and financial conditions worsened with the rise in volatility in financial markets. Rise in commodity and international crude oil prices became a major cause of inflation in India and around the globe. The fall in domestic demand correspondingly led to fall in private consumption. The inflation continued to rise in 2022 and peaked at 7.8% in the month of April. According to RBI's survey, the shortfall in Rabi production due to heatwave further exerted pressure on food prices (Reserve Bank of India 2022d). In August 2022, though the domestic demand improved with moderation of food prices and a cut in excise duty in petrol and diesel, the global economic and financial environment deteriorated marked by contractionary monetary policy adopted by most of the economies. US dollar reached record high which led to import inflation (Reserve Bank of India 2022e). A sigh of relief came in November when inflation eased to 5.9%, suggesting that the interventions made by the RBI and MPC were coming into effect. In the new Financial Year 2023-24, the inflation was well within the targeted range, except for July 2023 where a temporary spike in inflation was recorded at 7.4% due to high vegetable prices. By October 2023, inflation reached close to target level at 4.9% as global outlook and market sentiments improved.

The MPC decided to follow a calibrated conventional monetary policy which advocates for increasing the policy rate in order to curb inflation. This also follows the Taylor Rule which states to increase the interest rate in order to reduce aggregate demand, moderate inflation expectation back to the targeted level and restore macroeconomic stability (Taylor 1993). The first rate hike in India in alignment with the interest rate channel of the monetary policy transmission mechanism was undertaken when the policy repo rate was increased by 40 basis points from 4% to 4.40% (Reserve Bank of India 2022c), the first hike since May 2020. As per the interest rate channel of the monetary policy transmission mechanism, a rise in policy repo rate leads to a rise in the Weighted Average Call Money Rate (WACR), the operational target. This impacts a spectrum of other short-term and long-term rates in various types of financial



markets as well as the banks' lending and deposit rate, thereby influencing the aggregate demand and guiding the economy towards its objectives of economic growth and price stability (Dua, Pami 2020). The MPC continued its contractionary policy by raising the repo rate. In June 2022, it was increased to 4.9%, followed by successive hikes to 5.4% in August, 5.9% in September, 6.25% in December, and ultimately to 6.5% in February (Reserve Bank of India 2022d, 2022e, 2022f, 2022g and 2023a). Thereafter, as the inflationary pressure eased, the MPC decided to keep the rate unchanged thereon. Furthermore, the RBI also used the daily absorption under Liquidity Adjustment Facility (LAF) corridor as an integral tool to manage short-term liquidity. **The daily net absorption levels were brought down from ₹7.6 lakh crore in January 2022 (Reserve Bank of India 2022a) to ₹1.4 lakh crore in March 2023 (Reserve Bank of India 2023b) reflecting a shift towards tighter liquidity conditions.** Along with rate hikes, the RBI maintained regular credit flow in order to foster consumer and business confidence.

The government played a key role alongside the RBI in tackling inflation. The government focused on taking pro-active supply side measures in order to counter supply disruptions as a major cause of inflation was rise in input prices which transmitted to higher output prices (Reserve Bank of India 2022d). In its budget allocation, the government aimed to boost investment through increasing capital expenditure even as the domestic economy remained resilient against the global spillover shocks. Healthy balance sheets of banks and corporate seemed to anchor inflation expectations well (Reserve Bank of India 2023e).

Hence, a calibrated approach where the MPC primarily targeted rate hikes to control inflation along with daily absorption of short-term liquidity aided by government's efforts, yielded success in controlling inflation. Nevertheless, we observed lags in RBI's policy approach. The first sign of inflation was recorded in February 2022, yet the first rate hike was done in May, signifying an implementation lag. Similarly, inflation was brought under the range only in November 2022 even though the rate hikes continued throughout the year, reflecting a transmission lag. A notable aspect of RBI's approach was to avoid any outright Open Market Sale of government securities which under conventional monetary policy is a key tool to reduce



liquidity in the economy, perhaps to avoid disrupting government bond market and minimize volatility in times where fiscal borrowing was already elevated.

## US

The rise in inflation in the United States was a result of demand-supply imbalances resulting from supply chain disruptions and lockdowns across the world. The reopening of the US economy caused a sharp rebound in aggregate demand which contributed to the rise of price level (Federal Reserve 2021f). The Federal Reserve System has dual responsibility on its shoulders- to keep the long-run inflation rate at 2% and to achieve maximum employment. However, the geopolitical tensions and situations, such as the Russia-Ukraine war, affected the food and energy prices which led to aggravation of the inflationary pressures on the US economy.

In early 2021, the inflation in the US was below the long-run target of 2%. As a result, the FOMC maintained an accommodative stance and aimed to increase the inflation above 2% so that the average inflation comes around 2% and expectations could be well anchored (Federal Reserve 2021a). The inflation crossed the 2% mark in March 2021 and continued an upward trend thereon. By late-2021 and early-2022, an inverse relationship between unemployment rate and inflation rate-as advocated by the Phillips Curve (Phillips 1958)-emerged. This implied that the labor market was recovering well. While the Fed was getting success in achieving maximum employment, it constantly faced challenges in maintaining price stability. The food and fuel prices witnessed a rise due to geopolitical situations and tensions of war in the Europe.

Moreover, the reopening of the economy led to occurrence of pent-up demand resulting in a sharp rise in demand-pull inflation. The peak of inflation rate (PCE) in the US reached in the month of June 2022 at 7.1% (US Bureau of Economic Analysis 2024), the highest in over four decades and eased by December, highlighting that the interventions made by the Fed and the FOMC were successful. The disinflation trend continued throughout 2023 with PCE inflation reaching about 2.6% by December 2023.



The FOMC primarily used the Federal Funds Rate as the main instrument to curb the inflation aiming to affect the economy through interest rate channel (as discussed earlier). Although the inflation began to rise by mid-2021, the first rate hike was undertaken in March 2022 where the rate was increased to 0.25-0.5% (Federal Reserve 2022b). Over the next 16 months, the FOMC followed an aggressive contractionary monetary policy by further increasing rate to 0.75-1% in May 2022, followed by 1.5-1.75% in June, 2.25-2.5% in July, 3-3.25% in September, 4.25-4.5% in December, 4.5-4.75% in February 2023, 4.75-5% in March, 5-5.25% in May and ultimately to 5.25-5.5% in July (Federal Reserve 2022c, 2022d, 2022e, 2022f, 2022h, 2023a, 2023b, 2023c and 2023e). By mid-2023, the inflation had eased significantly, as a result, the committee decided to pause further rate hike and maintain target range of 5.25-5.5%. Along with FFR, Primary Credit Rate (It is the interest rate at which commercial banks and other depository institutions can borrow money directly from the Fed through the Fed's discount window) was also increased from 0.25% in early 2021 (Federal Reserve 2021a) to 5.5% by mid-2023 (Federal Reserve 2023e). Additionally, the FOMC tightened the liquidity situation in the country by reducing the Federal Reserve's balance sheet through a process known as Quantitative Tightening (QT). This involved allowing its holdings of U.S. Treasury securities and agency mortgage-backed securities (MBS) to mature without reinvestment. The level of net purchase of Treasury securities and agency MBS fell from at least \$80 billion per month and \$40 billion per month respectively in early 2021 (Federal Reserve 2021a)-during Quantitative Easing-to at least \$20 billion per month and \$10 billion per month respectively by 2022 (Federal Reserve 2022a). These net purchases officially ended in March 2022, marking a shift from Quantitative Easing to Quantitative Tightening. From June 2022, the Fed allowed securities to mature without reinvestment, with monthly 'runoff caps' of \$30 billion for Treasuries and \$17.5 billion for MBS (Federal Reserve 2022d), which were increased to \$60 billion and \$35 billion, respectively, in September 2022 (Federal Reserve 2022f).

Hence, the Fed through the FOMC followed an aggressive monetary policy and was able to tame down inflation in accordance with a systematic approach of daily-liquidity absorption. The Fed



also employed Forward Guidance, communicating about possible future policy path and rate hikes—through its monetary policy statements—so as to anchor expectations well. Nevertheless, the monetary policy transmission mechanism in the US also exhibited lags. The inflation began to rise by mid-2021, however, the first rate hike was undertaken only in March 2022, thus reflecting implementation lag. Furthermore, the rate hikes continued for next 16 months, but the inflation returned close to the target rate only by around end of 2023, hence demonstrating a transmission lag. This highlights the importance of timely intervention, clear communication, and a well-calibrated policy mix in managing inflationary shocks in large, dynamic economies.

### **Comparative Analysis**

The monetary policies of both India and US broadly relied on a similar approach towards controlling inflation post-COVID. The MPC and FOMC primarily relied on adjusting the policy rate to affect aggregate demand and curb inflation. Alongside, both the committees engaged in forward guidance respectively to anchor inflation expectations well and reinforce inflation-targeting credibility. The root cause of rise in inflation in both the countries was a surge in food and fuel prices due to supply chain disruptions, further aggravated by geopolitical tensions and war-like situations in Europe. Nevertheless, both Indian and US economy showcased macroeconomic resilience and adopted a systematic, data-driven calibrated approach. Furthermore, the presence of lags in the monetary policy transmission mechanism of both the economies highlights a key feature associated with monetary policymaking: it's delayed but powerful real impact on the economic outcomes.

However, there were certain differences as well between the two. For instance, although both followed a contractionary monetary policy, while MPC resorted to a more gradualist approach, the FOMC pursued an aggressive strategy. Additionally, the RBI through MPC avoided engaging in any outright Open Market Sale so as to prevent any potential distortions to the



Government-securities market. It relied on tools like Standing Deposit Facility (SDF) and Variable Rate Reverse Repo (VRRR) auctions to absorb excess liquidity. On the other hand, the FOMC strived towards absorption of daily-liquidity and pursued Quantitative Tightening by allowing its holdings of U.S. Treasury securities and mortgage-backed securities (MBS) to mature without reinvestment. Though it is not an active form of OMS, it had similar impact on financial conditions.

To summarise, the policy interventions made by RBI through MPC in India and the Fed through the FOMC in the US offer us valuable, comparable case studies of central banks' roles and actions in response to similar macroeconomic shocks tailored to their respective domestic economy structure.

## **Conclusion**

In conclusion, the paper has explored how the MPC in India and the FOMC in the United States undertook rate hikes to curb inflation in the post-COVID period. The MPC adopted a gradualist approach in raising the repo rate in order to avoid sudden shocks in the economy. The FOMC, on the other hand, pursued an aggressive stance by rapidly raising the federal funds rate. The paper has also examined key similarities and differences in their policy interventions. It provides insights into the role of timely actions and policy credibility in determining the effectiveness of the monetary policy. The study highlights the importance of the monetary policy in dealing with the challenges posed by macroeconomic shocks. As the world transitions into post-pandemic period, this research can serve as a reference in examining the long-term impacts of the interventions undertaken post-COVID crisis.

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