Infomerics Valuation And Rating Pvt. Ltd.

SEBI REGISTERED / RBI ACCREDITED / NSIC EMPANELLED
CREDIT RATING AGENCY

Dr. Manoranjan Sharma
Chief Economist, Infomerics Ratings, Delhi
and
Dr. Arun Kumar Misra
Associate Professor, Indian Institute of Management (IIM), Sambalpur

RBI'S JUNE 2022 MONETARY POLICY-PRE-POLICY EXPECTATIONS

7th June, 2022

MACROECONOMIC BACKDROP

The worst is clearly behind us post the COVID 19 pandemic and India is once again on a high growth trajectory. However, there are heightened geopolitical dynamics in the wake of the Russia-Ukraine war, the high fuel prices, elevated logistics cost and interest cost, volatile capital flows and exchange rate volatility and the scramble for safe haven and the attendant correction in asset prices. The emergence of newer variants of the pandemic and monkey-pox has also thrown a spanner in the Indian growth story.

The challenges at the present juncture include enhancing the share of manufacturing in India's GDP *vis-a-vis* average in low and middle-income countries; adequately capitalizing on the inherent labor and skill cost advantages to develop large-scale labor intensive manufacturing; simplifying complex land and labour laws; providing productive employment and to absorb out-migration of labour from agriculture; and strong macroeconomic fundamentals including low and stable rates of inflation and a falling fiscal deficit. There is thus a compelling need for structural reforms to drive economic reforms and balanced and inclusive growth.

In the steadily burgeoning literature on economic development in general and the transformation of the developing economies in particular, it is widely agreed that there is a strong case for broadening the process and accelerating economic development and making it more equitable. There is also a compelling need to accelerate the process of ease of doing business and reduce the cost by structural transformation while addressing the concerns of health, education and employment.

There are several other concerns, viz., 6.7-6.9 per cent fiscal deficit, 3 per cent Current Account deficit, sticky CPI inflation of over 6 per cent, the Rupee trading at 78 to the US Dollar, decelerating growth and high unemployment. These aspects need a revisiting of the policy options and structural reforms to meet 'the revolution of rising expectations' of India's growth

odyssey. The RBI's recent Annual Report stressed addressing supply-side bottlenecks, calibrating monetary policy to reduce inflation and boost capital spending. Inflation has been partly offset by removing customs duty on imports of raw cotton, reduced fuel taxes, rising exports steel duty, restricting sugar exports, etc. but these measures have a limited impact of about 60 bps on the inflation rate.

The RBI warned that the higher risk appetite of Nonbank financial companies (NBFCs) led to "*their size, complexity and interconnectedness*" posing a "*potential threat*" to India's financial stability. The RBI reduced regulatory arbitrage of large NBFCs making them almost on par with banks in regulatory oversight.

Growth with equity is an important goal of monetary policy of central banks across countries. Equity demands not only equitable distribution of income, but also inflation control. Inflation hurts the common people significantly, when the government's support in the supply-side is inadequate. India, being an emerging country, needs economic growth with an anchor on inflation. At present, the economy is emerging out of the Covid-induced economic recession, demand has surpassed the supply significantly. But supply-chain disruptions due to repeated lockdowns are still to be fully addressed, resulting in a sustained rise in inflation.

FALLING RUPEE

The spot selling of dollars; RBI measures to protect Rupee, Forex; depletion of foreign exchange reserves, etc. have sparked off considerable debates and discussions in several well-informed groups. While extensive research has been done both in India and other to ascertain the appropriate level of foreign exchange reserves, particularly for emerging market economies (EMEs) over the last thirty years, there is still no clarity on this issue. But a general consensus, which has emerged- a rough rule of thumb, so to speak- is that an import cover of 6 to 8 months should be enough to tide over any difficulty. Since we have an import cover of 12 months, we see no reason for concern-much less alarm.

There are two issues here:

1. The adequacy of the level of the foreign exchange reserves to meet the requirements of imports.
2. Volatility in the movement of the Rupee, particularly in relation to the US Dollar.

Let us not mix the two issues. There is still no concern, to my mind and understanding, in respect of issue no. 1.

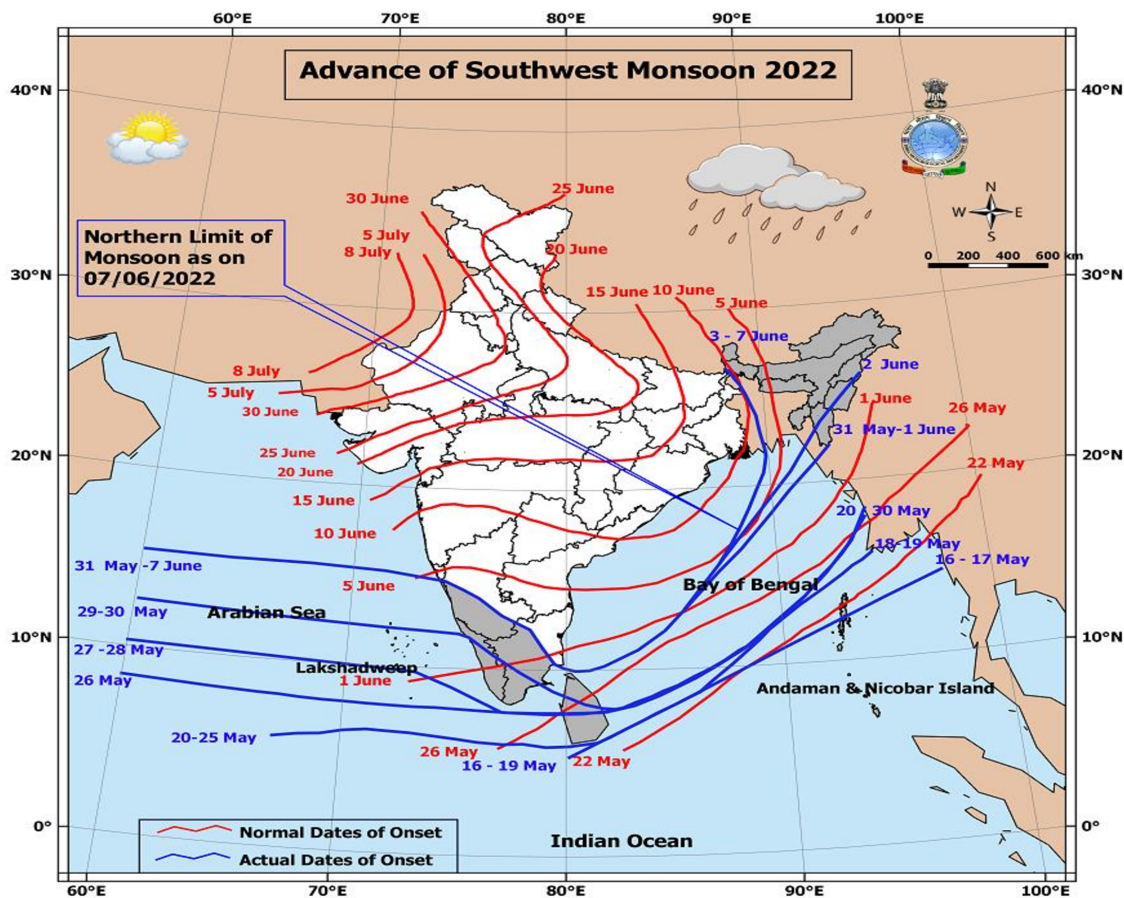
There is, however, a concern regarding the volatility and the fall in the value of the Rupee because of its implications for current account and fiscal deficits and other macroeconomic considerations.

INFLATIONARY SPIRAL

While economic growth continues to be fragile, the issue of elevated inflation has acquired centre-stage in India's development discourse. There have been significant increases in crude

oil price, along with prices of coal and other important minerals, depreciation of rupee and geopolitical uncertainty. All these forces have a cascading effect on the inflation.

The Annualised Consumer Price Inflation during April 2022 was 7 per cent and major items contributed to it were food, transport, fuels, electricity and hotels and restaurants. The inflationary WPI and CPI spiral causes concern with WPI and CPI inflation rising to 14.55 per cent and 6.95 per cent, respectively, in March 22. With peak summer on, it is expected that prices of food and electricity would further rise during the May- June 2022. As the Central Government has slashed fuel taxes, subsidised gas cylinders, capped sugar exports & permitted duty free import of 20 lakh tonnes of crude soya-bean oil and sunflower oil, it is expected that fuel price inflation may soften overall inflation. However, rising fruits and vegetable prices, global commodity prices and continued geo-political uncertainty may further raise inflation in the coming days. Hence high inflation concerns continue to persist, particularly since the underlying inflation is almost 7 per cent.



Inflation is a complex and multi-layered issue and there are no easy answers. Apart from the difficult macroeconomic setting, there are global issues also at play here. We also must keep in mind that inflation in the US is ruling at 8.5 per cent, which is a 40-year high. Again, in the UK, inflation is at 8.5 per cent, which is a 50-year high. The situation in Sri Lanka and Pakistan seems to be beyond redemption. We in India have lived with double-digit inflation at several points in our lives. Hopefully, a judicious mix of fiscal and monetary measures will

work and the situation does not degenerate into what is called "*stagflation*", which came into a sharper focus in the late 1970s in the USA.

In conformity with the mandate of the Monetary Policy Committee (MPC), the RBI should maintain the inflation at 4 per cent with a band of ±2 per cent. The twin responsibility of providing adequate credit at lower cost for growth and controlling inflation at around 4 per cent has become a critical policy issue for the RBI. At present, many banks have surplus liquidity and any increase in the CRR or the policy rate may not significantly increase the loan cost. But adequacy of liquidity may not be available once the agriculture loans peak-up during the 2nd quarter. The government has increased the agricultural credit target to ₹ 18 lakh crore for the 2022-23 fiscal from ₹ 16.50 lakh crore during last year. Significant part of this credit may disburse during the period May-July 2022, which may dry up the liquidity of many banks and the banking system may need continuous liquidity support. Hence, a monetary policy with an anchor on inflation is the need of the hour.

As per the FY 23 Budget, the gross market borrowing through dated securities has been pegged at ₹ 14.95 lac cr. It has been estimated that 60 per cent of the borrowing amounting to about ₹ 9 lac crore would be borrowed from market during the first half of the FY 23 which may harden the yield and affect the cost of borrowings of corporates. International price transmission has significant impact on domestic inflation in India. Global food prices, largely for cereals, edible oils and crude prices may further aggravate the inflation figure in the coming months.

Many countries have slowly reviving their accommodative monetary policy with upward revision of interest rate. Interest rate differential and competing currencies pressure has significantly affected the rupee value along with our merchandise trade account. These disconcerting aspects have implications for the twin Current Account deficit and the fiscal deficit. The concerns of a prudent fiscal policy as stressed in the Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) seem difficult to be met.

POLICY ACTION

In the light of this discussion and the evolving growth-inflation trade-off, it is expected that the RBI will change the stance of the monetary policy with a definite anchor on inflation. A rate hike in the June Policy is given because of the RBI Governor's unequivocal assertion that a rate hike at the June 8 MPC meet is a "*no brainer*". We expect the policy rate to go up by 35-50 bps. The RBI is, however, likely to continuously provide liquidity support through the LAF window to sustain the growth process. It would provide support to government borrowing programme while controlling the hardening of yield through policy twist. A series of rate hikes in FY 23 would also help the RBI to move towards a positive real rate of interest.