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ECONOMIC DIGEST

INFLATION ANALYTICS IN INDIA

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Introduction

In common parlance, inflation implies a general increase in prices and fall in the purchasing value of money. The simplest and classic definition of inflation for about a hundred years has been "too much money chasing too few goods". The inflationary spiral stems from high oil prices, disruptions in supply chain, particularly post Ukraine war, reduced production of goods, surge in wage bills and excessive deficit financing.

Almost all central banks hiked rates since April 2022 with the cumulative hikes being US 450 bps, Hong Kong 450 bps, Canada 400 bps, UK 350 bps, and Australia 350 bps. Such successive policy rate hikes by central banks pushed the treasury bills and bond rates quite steeply and the transmission to lending rates was faster than before. While the Fed Chief maintained that inflation control occupied overriding priority, the liquidity crisis in SVB, Signature Banks and credit stress issues leading to take over of Credit Suisse disrupted the financial system globally. Fed softened its stand with an increase of 25 bps in March and domestically the RBI paused. BoE and ECB through their continued aggressive stand on rate increase could not reverse the overarching negative sentiment in the financial system.

RBI's Role

The broad objectives of monetary policy in India relate to maintenance of a reasonable degree of price stability and adequate expansion of credit to foster faster growth. But the relative emphasis on these objectives differs because of varying socio-economic requirements and priorities, level of development, etc. The Preamble to the RBI Act, 1934 defined RBI's objective *"to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage"*. In line with this thought, the Urijit Patel Committee's report held: "*Drawing from the review of cross-country experience, the appraisal of India's monetary policy against the test of outcomes and the recommendations made by previous committees, the Committee recommends that inflation should be the nominal anchor for the monetary policy framework. This nominal anchor should be set by the RBI as its predominant objective of monetary policy in its policy statements. ...Subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth trajectory and financial stability*".

The Flexible Inflation Targeting Framework (FITF) was introduced in India post the amendment of the RBI Act in 2016. In accordance with the RBI Act, the Government of India sets the inflation target every 5 years with RBI's consultation. The inflation target has been mandated by the RBI Act, amended through the Finance Act, 2016 to be 4 % (+/- 2 %). The inflation target can be missed when:

- The average inflation exceeds the upper tolerance level of the inflation target as predetermined by the Central Government for 3 quarters in a row.
- The average inflation falls short of the lower tolerance level of the target inflation fixed by the Central Government beforehand for 3 consecutive quarters.

In the event of inflation averaging 6 % or higher for three consecutive calendar quarters, the statutory provision 45ZN in the RBI Act, 1934 is invoked requiring the Governor to explain the breach to the government. This issue is compounded by inadequate monetary transmission.

Successive rate hikes began with 40 bps hike from 4 % at an off-cycle meeting in May 2022, its first rate increase in nearly four years and, therefore, "*it is now necessary to evaluate cumulative effect of rate hikes*". Early signs of a slowdown were visible in bank credit growth which decelerated to 15.7 % y-o-y as of March 10, easing from decadal high of 17.9 % in October 2022.

Since the RBI had already raised rates by 250 bps since May 2022; the dip in retail inflation from a three-month high 6.52 % in January 2023 to 6.44 % in February 2023; and the "*downside risks from financial stability concerns*"- "*unprecedented uncertainties in geopolitics, economic activity, price pressures and financial markets*" (e.g., banking turmoil manifested in the crash of the Silicon Valley Bank, Credit Suisse Group AG), it refrained from any such hike even though inflation continues to breach the tolerance level of 6 %. This decision would provide relief to borrowers in rate sensitive sectors like real estate including residential complexes, passenger cars, commercial vehicles with the home loan and other EMIs unlikely to rise. Further, large debt companies, growth stocks, small and mid-cap space companies, and specific sectors, viz., consumer durables and real estate would not be adversely impacted by the RBI's policy move, business sentiments will improve by containing the rise in borrowing costs and thus augur well for broad-based Indian economy. Any further hike in the benchmark repo rate at this juncture would have affected India's economic growth even as domestic demand impulses remain healthy. However, the cost of wholesale borrowings in money markets could rise in money markets and corporates because of the RBI's decision to reduce surplus liquidity. Incidentally, this *status-quoist* decision of the RBI is in line with the decision of some other central banks in the region, including Indonesia, South Korea and Malaysia.

The sequential growth of CPI-core in March 2023 is the weakest since June 2022 because of the pass-through of declining WPI inflation in consumer goods prices. Although CPI for the full year rose from 5.5 % in FY22 to 6.7 % in FY23, it was much lower in the second half of FY23 at 6.1 % compared to 7.2 % in the first half.

Further Rate Hikes

The MPC remains focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth. The Governor did not explicitly say that there would be a rate hike post the next MPC meeting. But reading between the lines, the Policy statement is strongly suggestive of the fact that there could be one more hike because the "*war against inflation will continue until durable decline in inflation closer to target is seen*". The Governor said, "*the MPC unanimously decided to keep rates unchanged in this meeting with readiness to act if the situation so warrants*". "*The MPC will not hesitate to act as needed in future meetings*". While keeping the interest rate intact, the Governor stressed that core inflation remains sticky. Hence, the Repo rate could reach 6.75 % with a possible final 25 bps hike in the first half of FY24. But if growth continues to be resilient and inflation continues to move south, rate hikes would not be necessary.

Inflationary Spiral

High retail inflation since December 2022, spike in food inflation hiking retail inflation and persisting high core inflation across many goods and services cause concern and consternation. While headline inflation is likely to moderate in FY 24, the inflation trajectory would be a function of both domestic and global factors, viz., global dynamics, record rabi food-grains production, volatility in crude oil prices with potential high imported inflation risks, El Nino, etc. "Taking into account these factors and assuming an annual average crude oil price (Indian basket) of $85 per barrel and a normal monsoon, CPI inflation is projected at 5.2% for 2023-24, with Q1 at 5.1%, Q2 at 5.4%, Q3 at 5.4% and Q4 at 5.2%, and risks evenly balanced". In sum, the RBI has done well. But the RBI has its limitations in inflation control. Viewed thereof, there are several multi-layered issues involved in inflation management in India. Such issues include a review of inflation target, use monetary policy in tandem with effective fiscal measures and the impact of too much tightening on decelerating growth.