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"Rising inflation and impending recession everywhere, no growth anywhere! "

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Remember the lines from Samuel Taylor's Coleridge's, *The Rime of the Ancient Mariner*: "Water, water, everywhere, Nor any drop to drink!" The state of the world economy is similar to that of the legendary mariner, "alone, alone, all alone in a wide, wide sea".

With no latest data on retail inflation and industrial output, which were yet to be released only next day, Finance Minister Nirmala Sitharaman facing the reporters last week on October 11 during her visit to Washington to attend the International Monetary Fund (IMF)-World Bank Biennial Meeting had to be circumspect. She told them "the specifics of the next budget may be difficult at this stage but growth would receive top priority ….Inflation concerns will have to be addressed".

The data released next day revealed retail inflation in September was at a five- month high at 7.4%, up from August's 7%, and exceeding the permitted tolerance level of 6% for the ninth month in a row. Further, industrial output growth contracted to 0.8 percent in August, with decline in mining and manufacturing of consumer goods resulting from supply-chain disruptions of inputs from overseas and global slowdown due to Russia-Ukraine war adversely impacting trade and India's export earnings.

Last August after raising the policy interest rate by 50 bps to 5.40 % (the current rate effective from September 30, is 5.90%), RBI governor in his press conference observed that the Indian economy was an island of "macroeconomic and financial stability in the ocean of economic turmoil". The IMF's latest *World Economic Outlook, October 2022,* released before the biennial meeting confirmed RBI's assessment, although with downward revision of world growth forecasts putting India ahead with 6.8% for 2022 and 6.1% for 2023, followed by China, with corresponding rates of 3.2% and 4.4% .

Global economy

Global growth is expected to slow down to 3.2% in 2022 from 6.0% in 2021 and to decrease further to 2.7% 2023. This is the "weakest growth profile since 2001 except for the global financial crisis (2007-08) and the acute phase of the COVID-19 pandemic (2019-21)". Global inflation is forecast to rise from 4.7% in 2021 to 8.8% in 2022 but to decline to 6.5% in 2023 and to 4.1% by 2024. The inflation forecasts for the advanced economies for 2022 and 2023 are USA: 8.1%, and 3.5%, Eurozone: 8.3%, 5.7%; and emerging market economies are India: 6.9% and 5.1; and China: 2.2% and 2.2%.

The US Federal Reserve delayed its response to rising inflation ever since March 2021, when the targeted rate of inflation of 2% was breached. The US Federal Reserve (the Fed) Bank kept the policy rate low, as close to zero percent on the belief that signs of rising domestic price level were transient due to transitory factors. But soon, when inflation signs became "real", the Fed woke up and raised the rate in March this year to 0.25%, and in May to 0.75 % and steadily thereafter by month to month from June to September to 3.0 %.

That has created another "taper tantrum", similar to that of 2013-14 when the former Fed Chairman Ben Bernanke told the US Congressional Committee on May 22, 2013 that the Fed would soon end the quantitative easing which began in 2008 to fight the Great Recession began. The decision was not implemented however until late December 2013. Mere announcement was sufficient to trigger the reversal of capital flows to the US, the world's safe haven, from emerging market economies (EMEs), including India. Stock markets in EMEs crashed with their currencies plunging down against the US dollar.

In an open economy in the 21st century, global market sentiments seep through the 'porous sands of geographical borders' at the 'click of a mouse' at a lightening speed. Although US share in world merchandise exports is 8%, the dollar's share in world exports is 40%, as prices of the most of the traded commodities are denominated in US dollar. For many low income countries struggling to reduce inflation, the weakening of their currencies has made the fight harder. The Indian rupee has touched a new low at Rs 83 per US dollar on October 19. The IMF has estimated the pass-through of a 10 percent dollar appreciation into domestic inflation would be around 1 percent.

Two options

Would central bank intervention in the market to prop up the currency help? Or would the depreciation or free fall be allowed ?

As for the first, market intervention would be justified only for reducing high volatility and violent movements in exchange rate fluctuations. The limits to intervention are determined by level of foreign reserves. As regards allowing a free-fall in currency values, experience indicates such a step has been found ineffective, and market players would only continue waiting for further fall. This is known as presence of information asymmetry. The 2013-14 taper tantrum experience of five EMEs (Brazil, India, Indonesia, South Africa, and Turkey), referred to as fragile five, is relevant.

A former Indonesian Finance Minister Muhamad Chatib Basri who was handling the crisis in his own country, now a professor told the Monash University Seminar audience recently that expenditure cuts and other fiscal policy measures were more appropriate. He singled out India's success by reining government spending by trimming routine expenditure by 10 per cent. With trade deficit contained and current accounts deficit improved, the Indian economy was able to rebound. The lessons are clear: High current account deficits can make an economy vulnerable, particularly if financed through portfolio investments. Policy measures to ensure investor confidence is essential to maintaining stability. Exchange rate policy (allowing the exchange rate to depreciate) suffers from the problem of information asymmetry with higher risk in EMEs.

The alternatives are clear. IMF advises that in the short-run, monetary policy should aim at restoration of price stability; and fiscal policy aim at alleviate the cost-of-living pressures more with direct cash transfers to the poor while at the same time adopting a tight fiscal stance aligned with monetary policy. Structural reforms are purely national in character. They should support the fight against inflation by improving productivity and easing domestic supply constraints.

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