Where will inflation lead

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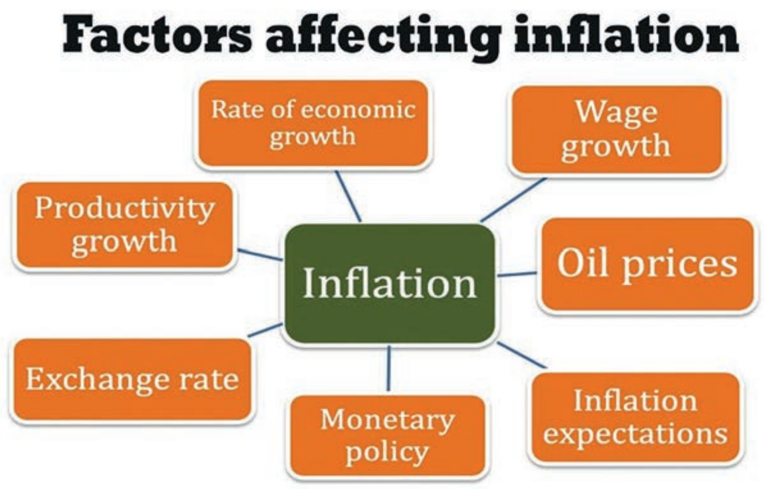


Surging inflation, depreciation of the currency and depletion of India's foreign exchange reserves are all signs of concerns. All of the above are interconnected. They fall under the category of macroeconomic indicators of the state of the economy. For India, a leading emerging market economy, with far greater global mobility, than ever before, of labour and capital, as well as that of goods and services besides export capacity in food grains, all these concerns are not new. They were faced by policy makers in the past. So, the points for consideration are:

- Were there not any lessons from the past?
- Are they not guiding us to avoid past mistakes?
- Are we taking more appropriate decisions?

The Reserve Bank of India (RBI), which felt four months ago like the US Federal Reserve Bank that the factors behind inflationary pressures mounting during past seven months were only transitory, has now confirmed in its Annual Report FY 2022 (released on May 26), that the ongoing Russian-Ukraine War and the resultant food supply crisis caused by fall in wheat production in Ukraine, supply- demand disruptions and deteriorating logistics, including port congestion and container shortages have played havoc. The report also says that cost pressures from high industrial raw material prices and increase in transportation costs caused by rising petroleum crude and petrol and diesel prices as well as supply-demand chain bottlenecks have been the chief reasons behind inflation.

Additionally for India, the RBI Annual Report for FY 2022 refers to the substantial wedge between the wholesale price index (WPI) based inflation (15.08%) and the consumer index (CPI) based retail inflation (7.79%) in April and highlights the associated risk in the midst of manufactured products inflation of "possible pass through of input cost pressures on retail inflation with a lag, although a slack in the economy is muting the pass through."

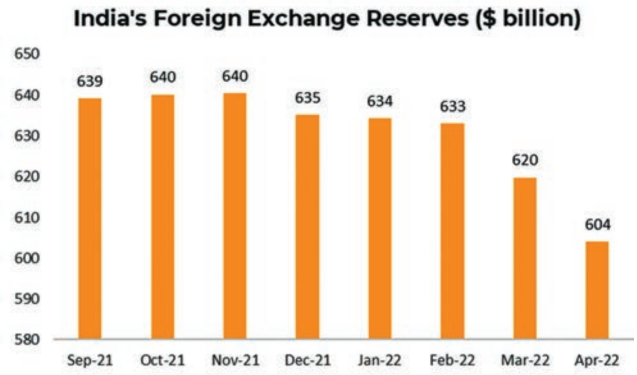
Just as a coin has two sides, the impact of inflation has two faces. One side is the domestic purchasing power of rupee. As inflation reduces the value of currency, the domestic purchasing power of the rupee falls. The other side, which is the external value of the rupee, also decreases. Inflation makes the rupee less valuable, as it buys less of foreign goods.

Surging Inflation

Retail inflation is the target rate for RBI since 2017, replacing the wholesale price index (WPI) based inflation. It is measured on the basis of CPI index of all final goods and services, The CPI based inflation is rising since May of last year **(Table 1)**. That was the time when the world economy recovered from the disastrous consequences of the worldwide Covid-19 pandemic, despite periodic emergence of new variants of the virus. Anticipating a revival of aggregate demand, the petroleum crude exporting countries started increasing the price of the crucial input, the lifeline of oil dependent developing countries. India's crude oil imports are about 20% of total imports. Nearly 85% of India's crude requirements are met by imports.

The world price of crude per barrel rose from $69 in May 2021 to $79 in September 2021 and was volatile with some slight fall until end December of last year. From January this year, the rise in crude prices was unstoppable. From $92 in January, it increased to $108 in April. In May, it surged to $117.21. As transport costs (diesel and petrol) are a major component in the pricing from raw materials to finished goods, vegetables to food grains and services as well, retail inflation is greatly influenced by the rise in the world price of crude.

Retain inflation shot up to 7.79% in April of 2022, the highest since May, 2014. Food inflation increased for the seventh consecutive month to 8.38%, a new high since November of 2020, with oils and fats (17.28%), vegetables (15.41%) and spices (10.56%) recording the biggest rises.




Jayanth Varma, professor, IIM-A

Ashima Goyal, former member, PM-EAC

Further, pressure stemmed from transportation & communication (10.91%). The April 2022 inflation of 7.79% exceeded the upper tolerance limit of 6%, (which comprises the target rate of 4% plus a margin 2%) for the fourth straight month. Food and beverages are 45.86% of the total weight index, miscellaneous accounts for 28.32% of which are transport and communication (8.59%), health (5.89%), and education (4.46%). Housing accounts for 10.07%; fuel and light for 6.84%; clothing and footwear for 6.53%; and pan, tobacco and intoxicants for 2.38%.

The RBI Governor Das explained that inflation was caused by "global commodity prices touching historic highs, pick-up in core (fuel and food) inflation, revision in electricity tariffs and the continuing war in Europe."

Delayed response by RBI

The monthly inflation figure for example, for March is known only in the second half of the following month, April. Hence, as the bi-monthly meetings of RBI's interest rate setting Monetary Policy Committee (MPC) are held in the first week of the month (April, June, August, October, December and February), the policy interest rate is decided based on old data. The MPC in its meeting on April 6-8, 2022 decided on the basis of February inflation, namely 6.07%, not the March inflation figure which was released on April 12 and not available at the time of MPC's monthly meeting. As RBI felt the breach in the targeted comfort zone of inflation of February was slight, it preferred no change in the interest rate at 4%.

Authorities were shocked when the March inflation data was released on April 12. It was much higher - at 7%. Had the MPC met a week later, the decision would have been different. The lesson is obvious: MPC should consider scheduling MPC bimonthly meetings in the third week of the month. The unscheduled meeting of MPC on May 4 did what was expected for controlling aggregate demand to curb inflation. It raised the policy interest rate, the repurchase rate (RPO) at which the central bank lends against bonds from the commercial banks to inject further liquidity into the system, making it costlier for banks to borrow as well as lending to investors and consumers. The RPO was raised by 40 basis points (bps) to 4.40%. The cash reserve ratio was also up by 50bps. The factors causing steady rise in retail inflation for the past seven months were no longer considered "transitory" but longer lasting. The RBI Governor Das explained that inflation was caused by "global commodity prices touching historic highs, pick-up in core (fuel and food) inflation, revision in electricity tariffs and the continuing war in Europe." The Deputy Governor, **Michael Patra** was more direct and blunt. He added, "Reversing the extraordinary accommodation - in terms of both the policy rate and liquidity-that was undertaken in response to the pandemic- is the right approach."

Two external members, Professors Jayant Varma and Ashima Goyal wanted front-loading of rate hikes to ensure that stakeholders understand the intent clearly: price stability is the primary goal of monetary authority. Although Professor Varma wanted a rise by 100bps, the MPC decision was to raise RPO only by 40bps.

Impact of depreciating rupee

A great deal of hesitancy and a pleasing approach of "extraordinary accommodation" have dented RBI's image of autonomy. Short term foreign portfolio investors have been pulling out funds in their perceptions that India was not considered "a safe haven" any more. As macroeconomic indicators deteriorated, investors were rattled by rising exchange rate risks and the hot money has been flowing out. Further, imports have become more expensive with the falling value of Indian currency.

Trade deficit for April is $20.11 billion compared to $15.29 billion a year earlier. Trading Economics reports that imports jumped 30.97% percent year-on-year to $60.3 billion mostly due to increase in purchases of petroleum, crude and products

India : Crude Price, Inflation and External Sector indicators: 2021 April to May 2022

	PETROLEUM			OTHERS			
	Crude Price	Crude Imports	Inflation	Exchange Rate	Trade Balance	Net FPI flows (Equities)	Foreign Reserves
Month	$/barrel	$ billion	Percent	Rupees per dollar	$ billion	$ billion	$ billion
2021 April	65.9	8.22	4.20	70.78	-15.10	-1.29	588
May	68.9	7.31	6.30	72.52	-6.28	-0.39	598
June	75.6	8.28	6.26	74.36	-9.40	2.36	609
July	74.7	9.62	5.59	74.34	10.97	-1.51	601
August	74.3	6.76	5.30	73.09	-13.81	0.28	633
September	78.6	13.59	4.35	74.19	-22.59	1.79	639
October	84.4	8.90	4.48	74.19	-19.7	-1.81	640
November	71.4	10.63	4.91	75.03	-22.91	-0.79	637
December	77.2	12.24	5.66	74.46	-21.68	-2.53	634
2022 January	91.7	8.40	6.01	75.03	-17.42	-4.46	629
February	95.5	11.98	6.07	75.49	-20.88	-4.74	631
March	109.8	16.25	6.95	75.90	-18.51	-5.39	617
April	108.3	NA	7.79	76.60	-20.11	-2.24	606
May 27	117.2	NA	NA	77.69	NA	-1.44	593

Source: Trading Economics; Reserve Bank of India, Monthly Bulletin (Various issues)
NA= Not available

(87.54%), electronic goods (32.88%); and coal, coke and briquettes (146.33%). Exports increased only 30.70% to reach $40.19 billion, mainly driven by sales of petroleum products (127.69%) and engineering goods (21.97%).

Shrinking foreign exchange reserves

Trade deficits have to be financed by running down foreign exchange reserves (forex). Forex are the assets held in foreign currency and in gold. Forex also includes special drawing rights from the IMF and marketable securities denominated in foreign currencies like treasury bills, government bonds, corporate bonds and equities and foreign currency loans. From a record level of $642 billion in September 2021, the forex level has been shrinking. The RBI's latest upward revision of RPO to 4.40% failed to stop capital outflows. The forex level is now $593 billion.

Lessons from the past

The past comparable crisis is that of 2013-14. The major difference between the "taper tantrum", crisis of 2013-14 as it is called and the current one India is going through is India's external position, which is far better than the one that prevailed in FY 2013.The term, taper tantrum denotes the efforts by the US central bank to slow down expansionary monetary policies, from low interest rates and quantitative easing and "extraordinary accommodation" over a period. The mere announcement of intention by the US central bank was sufficient. It resulted in the sudden and painful reversal of flow short-term funds from emerging market economies including India back to US. Chaos caused by taper tantrum in the world currency markets are well documented. The then prevailing global inflationary conditions with high crude prices above $100/barrel and the US central bank's tightening monetary policy measures were similar to the ones now being witnessed in current FY 22 and FY 23. The rupee depreciated from about ₹ 56/dollar at the end of May 2013 to nearly ₹ 69 three months later, a fall of nearly 25%. The RBI increased the REPO rate between September 2013 and January 2014 by 75 basis points to 8%. What came to rescue was the rise in FCNR(B) deposits, by

$30 billion, which helped RBI to stabilize the rupee.

Today in FY 2023, India's forex level can cover 10-month imports as against 7.8-month imports in FY 2014.

The lessons are clear

The country should strive towards building up foreign exchange reserves of sizable level, adequate to cover at least 18 months imports of goods and services. Imports, a function of growth would rise as growth rises. They would require more of petroleum crude and raw materials, including iron and steel and other growth enhancing inputs. The central government should promote foreign direct investment of long term in nature rather than worry about short-term FPI funds which are fickle in nature. They are well known for their destabilizing nature and tendencies to flow out in search of higher gains from interest differentials and exchange rate risks.

In the short-run, for keeping costs under control, fiscal policy actions including tax reductions on key inputs are needed. Reducing import duties on raw material used in steel and plastic industries and raising export duties on exports of iron pellets would be appropriate. Temporary bans on exports of wheat and sugar are fully justified in the face of world shortage in food grains and similar kinds of exports in the interest of national food security. Also are needed efforts to step up bringing more hectares under edible oil seed production including groundnuts and soya beans.

In the immediate period, any ongoing negotiations for new free-trade agreements should be suspended. Food self-sufficiency should be given high priority at all times, as political conflict situations including those across the borders are never predictable.

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