The Challenging Tasks before Policy Makers

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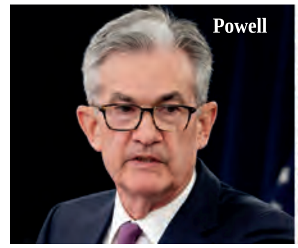
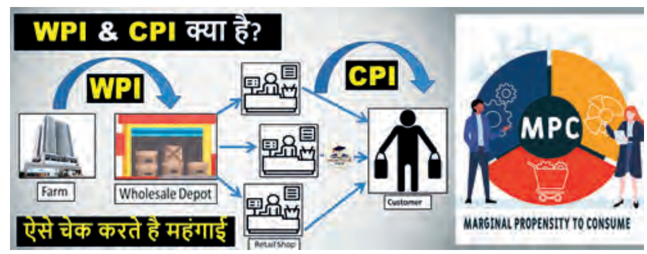
Finally on March 16, 2022, the United States (US) Federal Reserve (the Fed) did what it was expected to do. Since the summer of 2021, the central bank of the world's richest economy dismissed the signs of upward pressures on wages, rents and food prices as transitory. So did the Reserve Bank of India (RBI), until very recently. Now with the ongoing Russia-Ukraine war, the world is no longer the same. Things were already heating up with increases in wholesale price index (WPI) and consumer price index (CPI) based inflation, also known as retail inflation for February (Table).

The upward movements in key commodity prices such as petroleum crude and raw materials as well as food grains and steel and manufactured intermediate products including semiconductors and electronic chips are the principal causes. They were steady and steep, as supply-demand chain disruptions which duly reflected themselves in the shortages of shipping containers and ships, which represented emergence of inflation stemming from the robust recovery of the American economy.

The Americans became impatient and wanted the Fed to act quickly. There is no accepted definition of 'transitory' in economics. Only in January 2022, the Fed Chair Powell did not use the "T" word, as he surely and ultimately recognized





Crude Price in US$ and Retail inflation in percent
Developed Countries and India : March 2021 - February 2022
RETAIL INFLATION

Month	Crude Price (US$/barrel	USA %	UK %	EuroZone %	Germany %	Japan %	India %
2021 March	65.7	2.6	0.7	1.3	1.7	-0.4	5.5
April	65.9	4.2	1.5	1.6	2	-1.1	4.2
May	68.9	5	2.1	2	2.5	-0.8	6.3
June	75.6	5.4	2.5	1.9	2.3	-0.5	6.3
July	74.7	5.4	2	2.2	3.8	-0.3	5.6
August	74.27	5.3	3.2	3	3.9	-0.4	5.3
September	78.6	5.4	3.1	3.4	4.1	0.2	4.3
October	84.4	6.20	4.2	4.1	4.5	0.1	4.50
November	71.4	6.80	5.1	4.9	5.2	0.6	4.90
December	77.2	7.00	5.4	5	5.3	0.8	5.70
2022 January	91.7	7.50	5.5	5.1	4.9	0.5	6.00
February	95.5	8.00	6.2	5.8	5.1	0.9	6.10

the signs of revival of aggregate demand from the deep throes of the pandemic.

Looking at the historical developments since World War II, in regard to cycles of economic expansion and recession, people always remember the words of William McChesney Martin who had the longest tenure of 19 years, as he was the US Fed chair (1951-1970) under various Republican and Democrat presidents. He described himself as, "The chaperone who ordered the punch bowl removed just when the party was really warming up." He cautioned, "If we fail to apply the brakes sufficiently, and in time, we shall go over the cliff."

The Fed's huge task

The Fed ultimately indicated early this year in January, inflationary pressures had to be fought with appropriate monetary policy measures. The domestic and the world economy were duly informed that changes were coming up sooner than later. By the time, when on March 16, 2022, the Fed raised the key interest rate, known as the Fed Funds rate for the first time since 2018, the world inflation outlook of the year was overtaken by the Russian-Ukraine War, which began on February 24 2022, with no end in sight. The rate of increase was by a quarter percentage point from near zero. It is likely to be followed by a series of similar small increases in the coming months.

The task before the US Fed is huge. The economy is now facing the highest rate of inflation in 40 years at 7.9% February (year-on-year). Tightening monetary policy and absorption of liquidity with the reversal of quantitative easing and all stimulus measures, would hurt the economy. They would reduce demand for new housing, automobiles or home improvement projects, which would increasingly get more expensive, would lead to unemployment and reduce growth rate. The US policy makers have already reduced the gross domestic product growth rate estimates for 2022 to 2.8 % from the December 2021 projections of 4%.

With the new risks emanating from the Russia-Ukraine war, the estimates are now becoming meaningless. The US Fed Chair Jerome Powell noted, "You are looking at higher oil prices, higher commodity prices. That will weigh on GDP to some extent." For him, price stability is the immediate goal, although the Fed's twin objectives comprise both growth and price stability. Inflation in the US is running at 8%, four times higher than the Fed's target rate of 2% per year.

Equally unenviable task of RBI

While the wholesale inflation or producer inflation crossed 13% in February 2022 as against 12.96 in January 2022, because of the rise in basic metals, chemicals and chemical products, crude petroleum and natural gas, the retail inflation was at an eight-month high of 6.07%. in February. February is the second successive month when retail inflation was over 6% breaching the targeted rate of 4%, exceeding the 2% allowed

margin. February is the eleventh consecutive month when producer inflation is in double digits.

We may recall that the retail prices of petrol and diesel and LPG prices have been on hold since November 2021 and price of LPG since October 2021. With the hiking of prices in energy on February 22, 2022, the LPG price went up by ₹ 50 per cylinder. As I write this, petrol and diesel prices have been hiked for the fourth time in five days. The state-run retailers, who control 90% of the market, have been patiently waiting for 137 days. Prices have risen by a cumulative ₹ 3.2 per litre. The prices of petrol and diesel in Bengaluru are ₹103.93 per litre and ₹ 88.14 per litre.

Increases in the cost of transportation due to price revision of fuel would result in higher prices of goods in the wholesale market and of consumer goods and services in retail markets. The central government made it clear that the fuel prices had remained stable all these days despite the increase in global crude oil prices. Now the five state elections are over, the normal situation has returned with worldwide recovery impacting demand for energy in upward direction, prices have to go up. With the war in eastern Europe, geopolitical conditions have radically changed. Supplies of energy have been disrupted. The predictions on inflation would vary and none of them could be relied upon until after March data are available, which would be after the MPC meeting on April 8.

Disturbing predictions

The latest Bloomberg/Quint assessment based on the Deutsche Bank research note of March 22 says daily prices of 22 food items are up by 2.6% on a month on month (MoM) basis compared to a fall of 0.7% in February and inflation in edible oils and fats is 6.9% in March on MoM basis compared to 1.2% in February. Overall, expected retail inflation in March 2022 would be around 6.3% and would rise further to 6.3% in April 2022 as against the February rate of 6.1%. The MPC will only go by actual figures of February, which are now available.

The MPC will certainly undertake a review of economic growth. According to recent pronouncements of RBI Governor and Deputy Governor, growth is not that robust and sustained as witnessed in the US and other developed countries in recent months and latest pressures on crude oil prices are a result of supply side shocks. So, RBI presently seems to be inclined not to favour any change in the current accommodative monetary policy. It may like to wait, see and consider rate increases only in August/October 2022. It is obvious RBI does not want to sacrifice growth for controlling imported inflation transmitted by crude prices.

Rising crude prices and falling confidence

However, what we would actually experience would be the rising import costs of crude. Crude oil prices are not only volatile, but also in clear upward trend touching $ 130.30 per barrel on March 26 rising from $ 95.5% in February and $127.30 on March 7. Aside from contributing to retail inflation, the economy would have to incur higher trade deficits, higher current account deficits with net outflows of capital, triggered by lack of confidence in the Indian economy and fall in the external value of the rupee. In fact, the Indian rupee touched the lowest on March 7, 2022 at ₹ 77 per dollar. The Russia-Ukraine war no doubt had an adverse impact, casting doubts on the ability of India, as threats of economic sanctions against India were looming large, as India's neutral stand in the eastern Europe was not to the liking of the super powers. The overseas investors pulled out $9.646 billion during the week ending March 11, which is the single steepest weekly fall in the foreign exchange reserves. The country's foreign exchange reserves further declined by $2.597 billion in the week ended March 18, 2022, to stand at $619.678 billion. In rupee terms, the net outflows shot past one lakh crore in 2022, in less than three months.

Declining reserves affects the external value of the rupee adversely as more dollars have to be shelled out for the same level of imports of all goods, raw materials including the petroleum crude, edible oils and all manufactured goods, intermediate goods and final consumer goods, not to speak of overseas travel expenses including tickets, all to be paid out in hard currencies.

So, what are the options?

Keep the same interest rate policy, accommodative and growth enhancing? Wait for growth inducing more inflation with uncontrolled spending by the private sector, including consumption by the richer class on an easy interest rate structure? Or is there no role at all for the government, except watching the RBI to tackle inflation through monetary policy alone?

Certainly, there is a need to inspire confidence in the minds of overseas investors – the RBI will have to play a balancing act. Raise the key interest rate by 0.25% to impress upon them that price stability is still one of the twin goals. It is not sacrificed at the altar of growth and that at a high price of inflation exceeding the targeted rate of 6%.

The RBI would prefer that the government take a fiscal policy decision. If the central government reduces excise duties and suspends all planned increases such that petrol price would remain below the magic figure of ₹100 per litre and diesel price below ₹ 80 per litre.

It may be recalled that excise duties on petrol and diesel by ₹5 a litre and ₹10 a litre were reduced in November 2022. The Hindu Business Line reminds us that the State Bank of India researchers estimated that the November reductions, if continued, would result in a revenue loss to the Centre that could amount to ₹ 1-lakh crore, under assumption of an 8-10% per cent growth in fuel consumption for FY 2022-23. It is also to be stated the government had underestimated direct taxation revenue growth. With greater direct and indirect tax revenue collections, the net revenue loss would not be high. The central government should discontinue reliance on energy and reduce it from the presently estimated 20% indirect tax collections. Of course, the state governments have also to cut their tax rates on fuel.

That is difficult with different parties ruling them.

It is a cost- benefit game. The damage caused by fuel inflation is much more than revenue loss. The political gains for the central government need no emphasis, as the recent election results show. ■

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