Why should we wait for June? RBI should act now!

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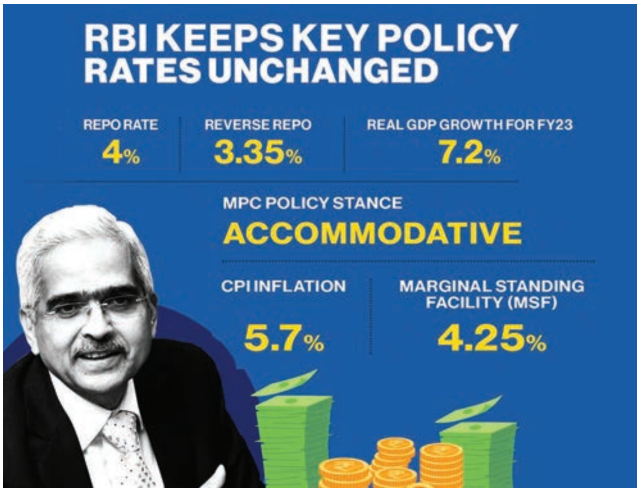
With inflation affecting all countries, advanced and emerging economies as well as developing countries with increases in prices of all goods, ranging from raw materials to finished products, food grains and vegetables and fruits to manufactured consumer goods and from petroleum crude to edible oil, and with the latest ban announced by Indonesia on palm oil exports to consuming countries, does India have to wait for a hike in interest rate by Reserve Bank of India (RBI)? The rate setting committee, known as Monetary Policy Committee (MPC) is scheduled to meet five weeks away, June 6-8, 2022.

Advanced countries and emerging economies have already taken steps in terms of anti-inflationary policies for containing the surge in aggregate demand in the midst of supply-demand disruptions and shortages of containers and shipping facilities and congestion in ports. The surge in demand stemmed from recovery of sorts, boosted by expansionary, loose monetary policies of near zero interest rates for fighting recession for last two years. The recession was caused by fall in consumption and investment following lock downs,closure of production units and lays-off, resulting in huge unemployment aside from loss of lives, all due to relentless of spread of Covid-19 pandemic. It was a silent destruction of the world economy for nearly two years without dropping a bomb: about nine months of 2020, whole year of 2021 and still continuing with the periodical emergence of new variants of the virus, resulting in the return of lockdowns and disruptions in economic activities.

RBI's April 8th decision

The RBI, responsible for monetary policy and duly mandated for maintaining price stability, and the central government, responsible for fiscal policy aim at the Consumer Price Index (CPI) based inflation, known as retail inflation, covering all final goods and services, The retail inflation target is 4% with an allowable margin of - 2% or +2%. The upper tolerance limit is 6%.

The April 8th decision by MPC for continuing the accommodative stance and keeping the policy interest rate REPO rate unchanged at 4% since May 2020, was based on a three-week old, February data on WPI and CPI inflation, which were released in mid March by government agencies. According to the current procedure of scheduling, the MPC



meetings are held in the first fortnight of the month. On the other hand, the inflation data, including wholesale price index (WPI) and CPI of previous month are available by the middle of each month. Thus, MPC meeting of April 6-8 did not have March inflation data but had to depend on February data.

The February data revealed that retail inflation, though close to 6% was just below the upper limit of 6%, at 5.95%. The RBI thought it would only be an aberration, since the economy was showing signs of recovery, though lopsided, as some sectors were still dormant and yet to pick up momentum.

The culprit which could damage the economy was the world price of crude oil. India imports nearly 85% of its requirements. The crude price has been not only on an upward trend but also volatile **(See Table)**. In its April 8 meeting, the RBI unanimously opted to change its policy stance from "remaining accommodative as long as necessary to revive and sustain growth on a durable basis" to "remaining accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth"

A rude shock

The March inflation data released in mid April after MPC'sd April 6-8 meeting shocked the nation. The whole sale price (WPI) index based inflation for March 2022 calculated on a year on year basis was 14.55%. The monthly retail

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

	Retail Inflation				INDIA					
	Crude Price	USA	UK	Euro Zone	India	Trade Balance	Current Account Balance	Foreign Excghange Reserves	NEER Index (Base 2015-16 =100)	REER Index (Base 2015-16 =100)
Month	(US$/barrel)	%	%	%	%	$ billion	$ billion	$ billion	Index	Index
2021 April	65.9	4.2	1.5	1.6	4.2	-15.1		588	95.01	103.94
May	68.9	5	2.1	2	6.3	-6.3		598	92.82	93.96
June	75.6	5.4	2.5	1.9	6.3	-9.4	-8.1*	609	93.96	102.23
July	74.7	5.4	2	2.2	5.6	10.97		601	93.61	104.36
August	74.27	5.3	3.2	3	5.3	13.81		633	93.21	103.62
September	78.6	5.4	3.1	3.4	4.3	-22.59	6.4*	639	93.77	104.80
October	84.4	6.20	4.2	4.1	4.50	-19.71		640	94.50	105.56
November	71.4	6.80	5.1	4.9	4.90	-22.59		637	93.60	105.45
December	77.2	7.00	5.4	5	5.70	-21.68	-23.0*	634	94.04	105.91
2022 January	91.7	7.50	5.5	5.1	6.00	-17.42		629	93.50	104.38
February	95.5	8.00	6.2	5.8	6.10	-20.48	NA	631	94.53	104.80
March	109.83	8.5	7.4	7.0	6.95	-18.51	NA	617	93.74	103.57
April 26	108.31	NA	NA	NA	NA	NA	NA	NA	93.31	103.08

Source: Trading Economics; Reserve Bank of India, Monthly Bulletin (Various issues)
* Current Account Balance figures are on a quarterly basis
NEER= Nominal Effective Exchange Rate (weighted by trade)
REER= Real Effective Exchange Rate (weighted by trade and adjusted for inflation overseas relative to inflation in India)
NA= Not available

inflation derived from March CPI index data was 6.95%, a 17-month high.

The March 2022 retail inflation was not only higher than the targeted rate of 4% but it also exceeded the upper tolerance limit of 6%. It was a close 7%. To be exact, which may give some satisfaction, it was only 6.95%. It is also the highest since October of 2020. *Trading Economics* reminds us it was above market forecasts of 6.35%.

Details of the March 2022 CPI data reveal food inflation recorded a sixth straight month to 7.68%, which is a new high since November of 2020. The sources of inflation for food inflation are oils and fats (18.79%), vegetables (11.64%) and meat and fish (9.63%). Other upward pressure came from prices of clothing and footwear (9.4%), fuel and light (7.52%), miscellaneous (7.02%), housing (3.38%) and pan and tobacco (2.98%).

Further, retail inflation has been above the 6% tolerance limit for a third month in a row. It remains to be seen what would be the full effect of crude oil price increases only when the April inflation are available in mid May. It may be recalled that the government delayed the pass-through of energy prices to consumers until the results of five state elections were announced.

It is worthy of note RBI has recently revised upwards its inflation forecast to 5.7% for FY 2022-2023 from 5.3%, citing surging commodity prices.

Can RBI change MPC meeting schedules?

The scheduling procedure of MPC meetings is the main reason for the rude shock. The monthly WPI and CPI figures of a given month say, January are released only in mid February. Had MPC waited for the March data on inflation, its decision would have been different. The Finance Minister Nirmala Sitharaman told the audience during a function organized by the Washington based Atlantic Council, “We have breached the 6%, but we have not really breached it so badly”, during her visit to Washington, D.C. for attending the bi-annual meeting of IMF/World Bank last month. These words from a finance minister would eventually go down in India's economic history as one of the understatements of the year.

It is clear that RBI has to act now. June is far off. The Table shows that foreign reserves are falling. During five weeks from March 1 to April 8, total decrease in foreign reserves were around $ 28.5 billion. Aside from financing imports, which were getting more expensive, foreign reserves appear to be used for stabilizing the rupee. The process is known as intervention and resorted to by all central banks. If supply of dollars add to domestic money and the increases in money supply are absorbed by central bank by issuing bonds in equivalent rupees, it is known as sterilized intervention.

If the nominal exchange rate (price of rupee in terms of units of foreign currency) is falling, RBI can supply more dollars and artificially cheapen the dollar, given the demand. That would would raise the value of rupee. The Table provides the data on weighted average of nominal effective exchange rate average of rupee value in terms of all major currencies, beside the US dollar, such as the Euro, and the British pound and the Yen, using the proportions of trade with the respective countries as weights. The changes in nominal effective exchange rate (NEER) index figures reflect the changes in the value of rupee overtime. The NEER when adjusted for relative inflation (ratio of domestic inflation to world inflation) is known real effective exchange rate (REER). That would give an idea of competitiveness of exports of India as well. Fall in REER index indicates that India's exports are more attractive; but on the other hand, it renders imports becoming more expensive. Central banks and governments all over the world are keen to maintain REER stable and avoid fluctuations.

It is the relative inflation that matters. While a country cannot change world inflation trends, it can do best to reduce domestic inflation through appropriate changes in monetary and fiscal policies. Fiscal policy is a blunt instrument. Changes do not bring out immediate results. But monetary policy changes are more effective. A rise in interest rate makes borrowing more expensive and discourages spending on housing and semi-durables. On the other hand, a rise interest rate encourages saving, given the inflation. It is the rise in real interest rate (nominal interest rate minus inflation) that matters. Fixed income earners and pensioners would reduce consumption, save more and and earn more interest income by putting their savings in banks as deposits if real interest rates are up.

Table gives more information about confidence in the economy. In a globalized economy, overseas investors rush to those countries which have sound policies to control inflation. The visible signs of falling confidence are clear. The short term funds invested in India, known as hot money are flowing out of the country seeking higher short term gains elsewhere. These and other adverse factors including the rise in world price of petroleum crude and other raw materials would

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contribute to widening of trade and current account deficits in balance of payments.

So, the only way out is to show that RBI means business: price stability is the prime concern. An immediate rise by 25bps in REPO would inform the markets here, domestic and overseas that RBI is back in the business of maintaining price stability, It would restore the credibility of RBI again. Another rise, by 25 bps in June MPC meeting would also ensure that RBI is doing the job.

One member of MPC has gone on record that there is no need for immediate change in the policy rate. The reason put forward is that "the forward guidance given in the last meeting effectively precludes such action. It is important to maintain the credibility of monetary policy communications, and deviation from prior forward guidance should be made only under truly exceptional circumstances".

These are extraordinary times. As the saying goes, "All's fair in love and war". The nation is fighting "a war" against inflation. That is an exceptional circumstance. We need exceptional action Deviation from prior forward guidance and assurance is fully justified. Raising the policy rate now is the need of the hour. ■

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