Stubborn Inflation in the "New Environment"

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Despite signs of decline, inflation continues to remain stubborn, surpassing the targeted rates set by central banks in the United States of America (USA), the United Kingdom (UK), the Eurozone (comprising 20 independent countries with a single currency), and India. In the USA, UK, and the Eurozone, the target is 2%, whereas India's inflation rate stands at 6.83%, higher than the 4% target set by the government and the Reserve Bank of India (RBI), with an allowable margin of 2%. This margin provides what is commonly known as the "comfort zone", allowing the RBI some flexibility in a predominantly agriculture-dependent country subject to the uncertainties of nature that impact farming activities. A review of inflation, its causes, and anti-inflationary measures taken by the governments and monetary authorities is in order.

A Review of Inflation Since 2021

The origins of this stubborn inflation can be traced back to the measures implemented to combat the much feared recession in the light of a deadly pandemic in early 2019. These measures encompassed both monetary and fiscal expansions aimed at mitigating the destruction of livelihoods and lives, which began with first death of a returning tourist from China due to an unknown virus, in Seattle, Washington State, in January, 2019. The virus, soon identified as COVID-19, quickly spread worldwide due to modern travel mobility between nations, leading to two years of misery and suffering, caused by lockdowns and loss of jobs and fall in output, in 2020 and 2021.

Monetary expansion and significant budget deficits, initiated to address this unprecedented crisis, introduced new concerns. These included the monetization of government deficits by borrowing from central banks, which has now been euphemistically termed "quantitative easing." A similar approach had been adopted during the financial crisis of 2005-2008 and during the "taper tantrum" characterized by a prolonged delay in adding to the money supply by the US Federal Reserve.

Other factors came into play as well. The disruptions in global supply chains caused by the COVID-19 pandemic were further exacerbated by Russia's invasion of Ukraine in February 2022. High food and fuel prices soared soon, 2022, bringing an end to the era of cheap gas flowing from Russia to European markets and disrupting food supplies. Both Russia and Ukraine were major exporters of cereal crops, contributing to the rise in global inflation as export prices for capital and consumer goods increased.

The net result of these factors was a 6.3% reduction in per capita income in developing countries and a 2.8% reduction in advanced economies. While vaccines were successfully developed and distributed in advanced countries and India, inflation remained persistent. Central banks, including the US Fed and RBI, initially believed that the factors driving inflation were "transient and transitory" when inflation reached 9.1% in April 2021. However, they were slow to respond. Eventually, the Fed began raising its policy rate range, starting at 0.25% and gradually increasing it (**Table**).

Table 1 shows that in 2022, after the pandemic began to recede, inflation, while declining from its peak of 9.1%,in March 2022. It remained high and well above the targeted 2%. Similar trends were observed in the UK, Europe, and India, where inflation rates exceeded their respective targets. Continuous increases in policy interest rates and measures to absorb excess liquidity, such as the RBI's withdrawal of ₹ 2000 currency notes in exchange for smaller denominations and higher cash reserve ratios on incremental cash deposits, contributed to reducing inflation in India (**Table 1**).

Review of Monetary Policy Changes

An analysis of monetary policy rate increases in the current episode (2021-2023) reveals notable measures actions by central banks. In the USA, the Fed raised its policy interest rate by 525 basis points since March 2022, increasing it from 0.25% to 5.50% in July 2023, marking the highest level in 22 years. The Fed maintained the rate unchanged in August and again in September 2023. The Bank of England (BoE) raised its policy rate to 5.25% in August, marking the 14th consecutive hike, as inflation steadily decreased from a peak of 10.40% in February 2023 to 6.7% in August. On September 21, the BoE decided to maintain the rate at 5.25%. Meanwhile, India has held its policy rate steady at 6.50% since February 2023, despite inflation peaking at 7.44% in July, primarily due to El Niño weather conditions causing food inflation. As food inflation subsided, headline inflation fell to 6.83% in August 2023. The core inflation, which does not cover the price rises in food and fuel was below 5%, as both are considered volatile in nature, because of their seasonality in nature; and

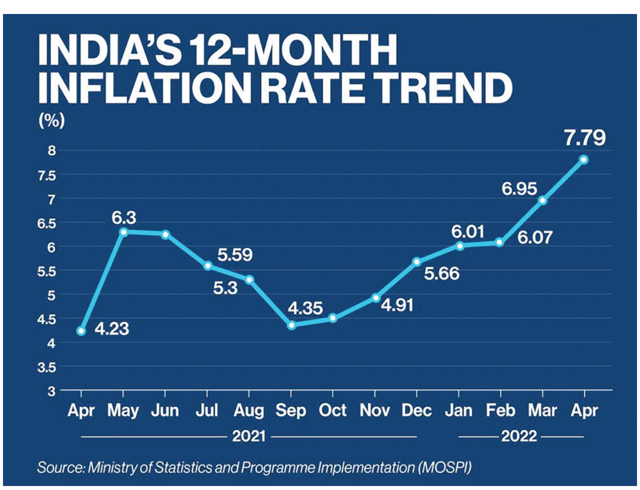
TABLE | Inflation and Interest Rates in Advanced Countries and India

Year & Month	USA		UK		EURO zone		India	
Month 2022	Inflation (Y to Y)	Interest Rate	Inflation (Y to Y)	Interest Rate	Inflation (Y to Y)	Interest Rate	Inflation (Y to Y)	Interest Rate
January								
April	7.50	0.25	4.40	0.25	5.11	0.00	6.01	4.00
July	8.30	0.50	7.80	0.75	7.44	0.00	6.95	4.00
Oct	8.50	2.50	10.10	1.25	8.87	0.00	6.70	4.00
2023	7.70	3.25	11.10	2.25	10.62	1.50	6.77	5.90
January								
February	6.40	4.50	10.10	3.50	8.64	2.00	6.52	6.25
March	6.00	4.75	10.40	4.00	8.50	3.00	6.44	6.50
April	5.00	5.00	10.10	4.25	6.88	3.25	5.66	6.50
May	4.90	5.00	8.70	4.25	6.96	3.25	4.70	6.50
June	4.00	5.25	8.70	4.50	6.10	3.50	4.31	6.50
July	3.00	5.25	7.90	5.00	5.50	3.50	4.87	6.50
August	3.20	5.50	6.80	5.00	5.30	3.75	7.44	6.50
Sept	3.70	5.50	6.70	5.25	5.30	3.00	6.83	6.50
	TBA Oct	5.50	TBA Oct	5.25	TBA Oct	3.75	TBA Oct	6.50

Notes : TBA Oct : To be announced in October | Sources : Trading Economies; European Central Bank; and Statista

uncontrollable, as the oil exporters are an oligarchic entity. The niceties in definitions make policy makers comfortable but not the common man.

The Eurozone, comprising 20 countries, has been grappling with high inflation since the beginning of 2022. Over the past 15 months, the European Central Bank (ECB) steadily increased its key policy rate (deposit rate), reducing inflation from 7.44% in April 2022 to 5.3% in June 2023. However, it remains more than double the 2% target. The ECB announced



Source: Ministry of Statistics and Programme Implementation (MOSPI)

that the current series of 10 rate hikes would be the last, given the challenges posed by the struggling economy, high borrowing costs, and a slowdown in China, its largest trading partner.

The recent decisions by major central banks to pause rate increases largely echo the concerns expressed at the annual meeting of central bankers organized by the Fed in Jackson Hole, Wyoming, in late August, 2023. The consensus is that "rising trade barriers, aging populations, and a transition from fossil fuels to renewable energy", which were referred as "New Environment" by **ECB President Christine Lagarde**, would impede central banks' ability to reach their inflation targets. Research presented at the August 2023 Jackson Hole Symposium suggests that greater integration of world economies, increased mobility, and trade liberalization allowed advanced countries to benefit from products produced in low-wage countries at lower prices, albeit at the expense of domestic manufacturing jobs in high-wage countries. Investments in renewable energies and demand for raw materials are contributing to inflation. Additionally, the aging population in the West, less likely to be employed, is creating labour market tightness, resulting in another supply shock, akin to those experienced during the COVID-19 pandemic. ■

In her address to the Jackson Hole Symposium, ECB President told audience that the new environment would give rise to much larger price shocks than those what the world experienced before the pandemic. She emphasized that higher investment needs and increased supply constraints would exert stronger pressures on markets for metals and minerals crucial for green technologies.

The conclusion drawn from the trends discussed at the Jackson Hole gathering of central bankers is that achieving previously set targets would be more challenging in the future. Following the recent decisions not to raise policy rates further, central bank chiefs indicated that these decisions were tentative and prepared stakeholders for rate hikes if necessary. The Fed chair stated that one more hike would be required by the end of 2023. Andrew Bailey, the Bank of England's governor, who cast the decisive vote in favour of a pause, conveyed that the Monetary Policy Committee (MPC) was divided 5-4, with a minority advocating for a further quarter-point increase. He emphasized that although inflation had significantly decreased in recent months, continued vigilance was essential, suggesting that BOE stood ready to take further action if needed.

Meanwhile, oil-exporting countries are taking advantage of this opportunity, causing oil prices to rise once again. The decision of the six-member MPC Meeting scheduled for October 6-8 will have to rely on inflation data of August 2023, as September's figures will only be available around October 11, 2023. It is advisable for the RBI to schedule its bi-monthly MPC meetings in the third week, following the release of the previous month's inflation figures. This suggestion has been previously proposed in these columns over the past several years .

With more than usual anxiety, especially about the "new environment", stakeholders in India will wait for RBI decision. ■

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