Soft landing or hard landing?
A grim choice before RBI

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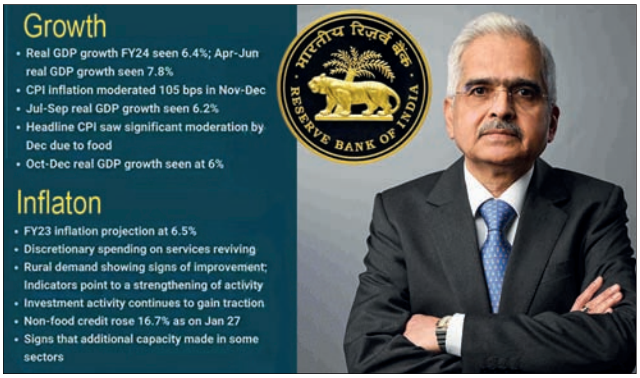
The interest rate setting committee known as Monetary Policy Committee (MPC) comprising six members (with three official and three independent, external members) and chaired by Governor, Reserve Bank of India (RBI) held its last of the six bimonthly meetings for the FY 2023-24 on 6-8 February. The purpose of the routine meeting is to undertake a review of economic performance and an assessment of the current global and domestic factors, and to decide upon the policy interest valid for next two months.

The policy interest rate is known as REPO, which is an abbreviation of interest rate in the operations (in purchase or sale of government securities held by commercial banks and other authorized institutions, a form of short-term borrowing, not more than three months). In other words, it is the rate at which RBI lends to banks and authorized financial institutions against government securities, for short term purchase and resale/borrowing is the policy interest rate,

The objective of RBI is to achieve two goals, (i) price stability, an exclusive goal and (ii) economic growth, a shared goal. Price stability is the primary objective, an agreed target between government and RBI, namely 4% per annum. The RBI has full responsibility and is accountable for maintaining stability. The target rate is calculated on the basis of consumer price index change in a given month compared to that of the same month in the previous year (annual percent of change in the CPI). The RBI has full freedom to use its policy instruments at its disposal.

On the other hand, the government of the day has the responsibility of reaching growth rate goals based on income and expenditure and growth objectives, which is a shared objective with RBI. Here comes the need for consultation and coordination, as persistent and continuous budget deficits have been empirically tested and verified to be inflationary. The dictum of the **Nobel Laureate, Milton Friedman**: "Inflation is a monetary phenomenon anywhere and everywhere", is now universally accepted.

In the measurement of inflation, as a percentage of change in the consumer price index of a given month over the same month in the year, known as CPI based inflation or headline



inflation. It is commonly called inflation. However, two items, fuel and food are excluded from calculation for CPI to arrive at a measure called core inflation, since the prices of petrol and diesel and natural gas as well as food grains and vegetables are often volatile and transitory in nature. About 85% of India's fuel requirements are imported from overseas and their prices are subject to global uncertainties and risks, which include disruptions in trade caused by conflicts in the middle east, and recently in Europe by the shooting war between Russia and Ukraine. As far as food is concerned, the uncertainties are caused by domestic weather conditions, including the El Nino phenomenon, which are beyond the control of national governments.

"Comfort Zone"

The central government and the Reserve Bank have agreed on an upper limit of 6% for peak inflation and a lower limit of 2%, either way (4% + 2% or 4% -2%). This is called a comfort zone, facilitated by acceptance of a margin of +1% either way. The main reason is that, being an agricultural country, India's food prices depend on the vagaries of nature and the monsoon. However, RBI governor, is fully aware that the consumer does not care about the fine, subtle difference between the two; and the CPI based inflation rate is their main concern. He has taken pains and been clarifying from time to time that the monetary policy target is only 4% and the upper limit of the comfort zone (6%) is not our target. The main policy goal of RBI is to achieve and stabilize inflation at 4%. Price changes in food and fuel are themselves reflected in CPI based inflation or headline inflation.

Unchanged policy interest rate

When MPC held its meeting on February 6-8, 2024 they had three months' inflation rates of 2023 before them: 4.3% in October, 5.55% in November and 5.69% in December. A completed month's data is available only in the second week of the following month. Therefore, the February meeting held did not have the inflation data of January. I have been writing in these columns often that MPC may consider holding the meeting in the third week so they would have the inflation data of the previous month as well.

The last quarter of the calendar year 2023 witnessed inflation rise from 4.3% in October to 5.55% in November and 5.69% in December. That was the latest information available to the MPC meeting of early February. As the inflation was on the rise, the committee decided to continue with the 6.50% rate on the basis of December 2023 inflation. The MPC announced on February 8, at the end of its meeting, the policy interest rate at 6.50% would remain in effect until its next bi-monthly meeting (April 3-5) in view of both global uncertainties and domestic conditions. Just after five days, on February 13, January inflation data were released, which revealed January inflation has come down to 5.10%. There arose a fair question

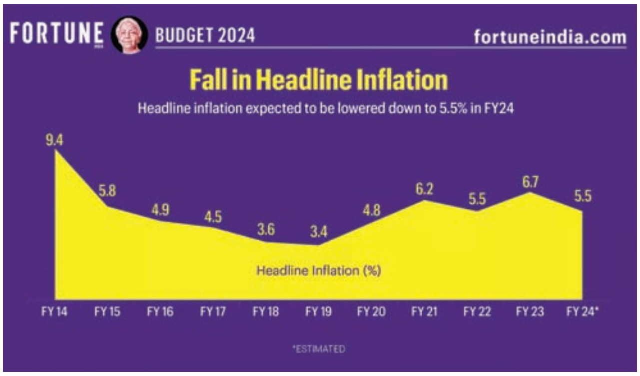


TABLE : 1 — Global Inflation (percent change compared with same month of the previous year) and Interest Rate (percent)

Year and Month	USA Inflation %	USA Interest rate %	UK Inflation %	UK Interest rate %	Euro Zone Inflation %	Euro Zone Interest rate %	India Inflation %	India Interest rate %
2022								
Jan	7.50	0.25	4.40	0.25	5.11	0.00	6.01	4.00
Apri	8.30	0.50	7.80	0.75	7.44	0.00	6.95	4.00
July	8.50	2.50	10.10	1.25	8.87	0.50	6.75	4.00
Oct	7.70	3.25	11.10	2.25	10.62	2.00	6.77	5.90
Dec	6.50	4.00	10.50	0.04	9.20	2.50	6.50	6.25
2023								
Jan	6.40	4.25	10.10	3.50	8.64	2.50	6.52	6.25
Feb	6.00	4.50	10.40	4.00	8.50	3.00	6.44	6.50
March	5.00	4.75	10.10	4.25	6.88	3.50	5.66	6.50
Apri	4.90	5.00	8.70	4.25	6.96	3.50	4.70	6.50
May	4.00	5.00	8.70	4.50	6.10	3.75	4.31	6.50
June	3.00	5.25	7.90	5.00	5.50	4.00	4.57	6.50
July	3.20	5.25	6.80	5.00	5.30	4.25	7.40	6.50
Aug	3.70	5.50	6.70	5.25	5.30	4.25	6.83	6.50
Sept	3.70	5.50	6.70	5.25	4.30	4.50	5.02	6.50
0ct	3.20	5.50	4.60	5.25	2.90	4.50	4.87	6.50
Nov	3.10	5.5	3.90	5.25	2.40	4.50	5.55	6.50
Dec	3.40	5.5	4.60	5.25	2.90	4.50	5.69	6.50
2024								
Jan	3.10	5.5	4.00	5.25	2.80	4.50	5.10	6.50
Feb	TBA March	5.5	TBA March	5.25	TBA March	4.59	TBA March	6.50

TBA: To be announced in mid March

in the public mind: Should the Reserve Bank continue with this high rate? Also, inflation remained within the comfort zone for the fifth consecutive month (2%-6%). So, another question bothered the public mind: Why is the interest rate still so high?

The Reserve Bank's view

RBI's view is different. Governor Shaktikanta Das has for the past several months been informing the nation through press conferences to business and industrialists and occasional public speeches that the journey to end the war against inflation is not complete as the global uncertain economic conditions have not improved. The RBI's high interest rate (6.50%) is due to both global uncertainty and domestic conditions. For a shift to ease the tight monetary policy. RBI is waiting for a firm and continuous downward trend for more than three months, in inflation.

The volatility rise in prices has been on a higher side in regard to much-needed petroleum crude and imports of food and fuel and cooking oil. Their import price determines domestic prices. International prices are beyond India's control. In late 2021, some countries adopted a tighter policy by immediately raising policy interest rates in October 2021 as the Covid pandemic receded and economic growth picked up. India is one. The advanced countries woke up only after the Ukraine-Russia war started in March 2022. Ukraine - Russia-Ukraine started affecting world prices of critical important imports, fuel and wheat imports from Russia and Ukraine. After the start of the Ukraine-Russia war, the US Federal Reserve raised its low interest rate (0.25%) to 0.50% in July 2022; and that too, only after July 2022 as global inflation picked up. And over the next 12 months, the US increased its interest rate to 5.50%, in July 2023. This rate still continues. (**Table 1**)

India hiked its interest rate from 4% in February 2022 to 6.25% in January 2023. With India's inflation hovering around 7%, the repo rate was hiked to 6.50% in February 2022. It still continues. Raising interest rates helped reduce inflation rates in the US to 3.2% in October and 3.1% in November 2023. But uncertain circumstances (Israel-Hamas conflict in October 2023 and disruptions in crude supplies, the drone attacks on shipping services in the Red Sea under proxy war between Iran and the US) still persist.

Domestic factors

Apart from global factors, there are domestic factors that need to be considered by the RBI. Domestic factors include weather-related reasons (heavy rains, hail storms, and low reservoir levels in Maharashtra, Gujarat and West Madhya Pradesh), which would affect the supply situation for the next three months. They are also caused by late sowing. These uncertainties led the RBI to continue tightening policy for another two months till April 2024.

TABLE : 2 — India: Food Inflation, Core Inflation and CPI based Headline Inflation (in percent)

YEAR/ Month	Food Inflation	Core Inflation	Headline Inflation
2022			
December	4.19	6.10	5.72
2023			
Jan	5.94	6.10	6.52
Feb	5.95	6.10	6.44
Mar	4.79	5.95	5.66
Apr	3.84	5.20	4.70
May	2.91	5.02	4.25
June	4.49	5.10	4.80
July	11.51	4.90	7.44
Aug	9.94	4.80	6.83
Sept	6.56	4.50	5.02
Oct	6.61	4.20	4.37
Nov	8.70	4.10	5.35
Dec	8.36	3.89	5.69
2024			
Jan	8.30	3.60	5.10
Feb	TBA	TBA	TBA

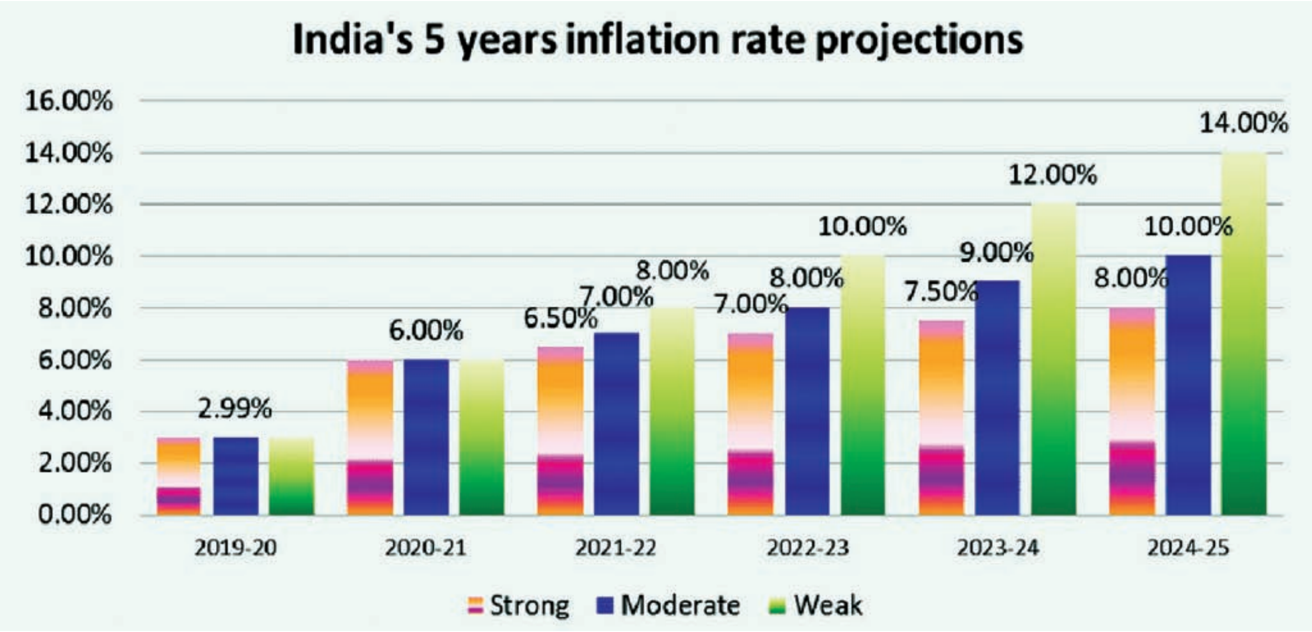
Notes TBA: To be announced in mid March

Prof. Ashima Goyal, the non-official of MPC who voted to keep the interest rate at 6.50%, in her speech at a conference on monetary policy in Kozhikode on February 15, noted that food inflation came down from 9.53% in December 2023 to 8.30% in January 2024; and headline inflation fell from 5.69% in December 2023 to 5.10% in January 2024 (**Table 2**). The trend in inflation is likely to be in the same direction as core inflation, which she hailed as good news.

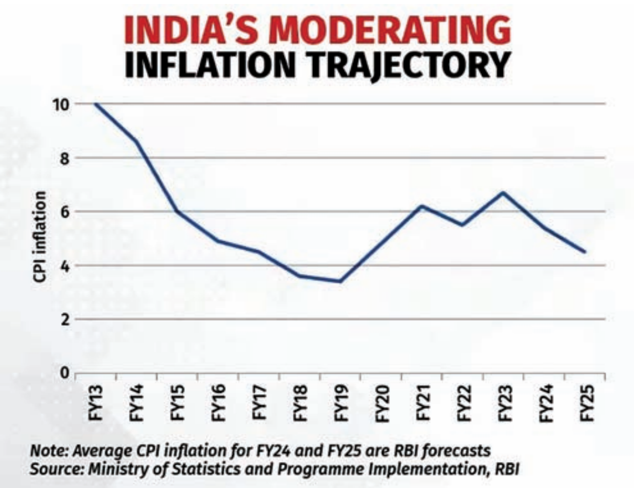
A new concern

The global debate has shifted away from the size of inflation to the pace of inflation. The RBI appears wary of the speed of landing. The governor, in his statement, noted that the last mile of inflation remains challenging and could be affected by food price shocks. Inflationary expectations for the financial year 2024-25 have been pegged at 4.5%, higher than the target rate of 4%, stressing that RBI wants to see inflation come down to 4% on a 'sustained basis'. Estimates for the four quarters of 2024-25 are 5%, 4%, 4.6% and 4.7% respectively.

The UK is now officially declared to be in recession. For the past two quarters, (July-September, and October-December



2023), its growth was negative. So the UK joins Japan in the list of countries in recession as of now, among the Group of Seven advanced countries. Does it not convey a clear message that interest rate cuts should be timely when signs of deflation were clear?



The RBI's position is there are no clear signs about India's deflation. We have sufficient warnings that any premature cut in interest rate is as dangerous as delay, as indicated by the UK case. One of the findings of an IMF's technical study ("A study of 100 inflation shocks since the 1970s provides valuable pointers for policymakers today", Finance and Development, December 2023) is: "Those central banks, which have historically celebrated victory over inflation but and loosened policy prematurely in response to an initial decline in price pressures, have suffered more. This was a mistake because

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inflation soon returned. Denmark, France, Greece, and the United States were among nearly 30 countries in the sample to loosen policy prematurely after the 1973 oil-price shock."

The study adds that 90% of the countries that failed to resolve inflation saw prices rise "slow sharply in the first few years after an initial shock, only to accelerate again or become stuck at a faster pace."

In the current scenario any central bank needs outstanding leadership. Recent experiences have proved we have it. Readers are aware that RBI Governor Shaktikanta Das was awarded an A+ rating in the Global Finance Central Banker Report Cards 2023 last October. The award recognizes three central bank governors who have excelled through originality, creativity and determination. Besides, India's central bank Governor, the other two are central bank governors of Switzerland and Vietnam. ■

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