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INFLATION IS DOWN - BUT RBI REMAINS VIGIANT

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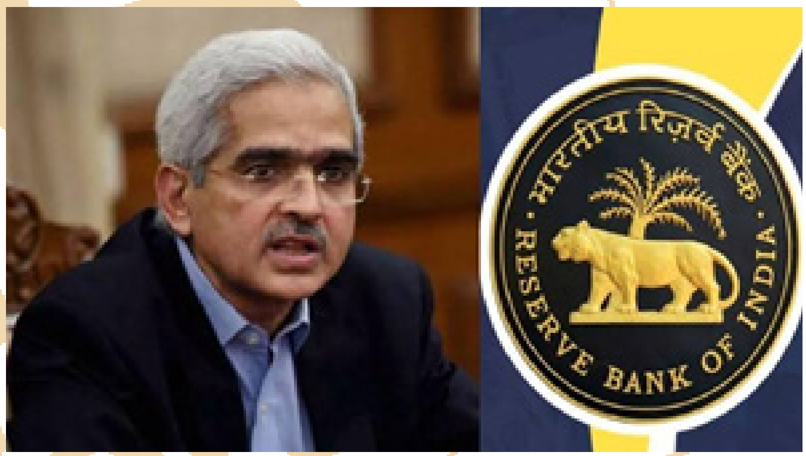

The Monetary Policy Committee of the Reserve Bank of India (RBI) has preferred to stand put than surprise the way it did in April. That is par for the course. The inflation print for the last two months seems to indicate that the peak has been passed: The wholesale price index (WPI) inflation fell to -0.9 per cent in April from 1.3 per cent in March, while the consumer price index (CPI) inflation declined to 4.7 per cent from 5.7 per cent. We expect the pause to continue through 2023.

The RBI has communicated that its fight against inflation is not over till it is aligned with its target of 4 per cent on a durable basis. This implies it will not be in a hurry to cut rates. We foresee a rate cut only in January-March 2024.

While a likely end of the rate hike cycle in advanced countries over the next couple of months will help, softening domestic inflation is swaying Mint Road. Additionally, the withdrawal of Rs 2,000 bank notes, 50 per cent of which have been returned, is expected to inject liquidity into the system.

Meanwhile in the US, tightening financial conditions, amid the banking stress, helped the Federal Reserve (Fed) by creating a downside to growth and inflation. The enduring gap between Fed's communication and market expectation is narrowing and the markets now see the Fed funds rate at around 5 per cent at the end of the year compared with below 4 per cent a couple of months back. Fed's mid-June rate decision will be a close call. That said, a "higher for longer" scenario looks more likely in the US, given above target inflation and the strength of economic activity there.

In Europe, however, core inflation has been quite sticky, and the European Central Bank is likely to continue raising rates. Interestingly, the Bank of Canada and the Reserve Bank of Australia raised interest rates in June. On the other hand, most emerging markets have seen the peak of the rate hiking cycle.

In India, a sharper-than-anticipated decline in inflation in March and April was driven by base effect and a correction in commodity prices, which had spiked due to the Russia-Ukraine conflict last year, creating a favourable statistical base effect. Although the favourable base effect will fade over the next few months, we expect consumer inflation to average 5 per cent this fiscal as compared to 6.7 per cent last fiscal.

Normal monsoons are important for a durable decline in cereal inflation, which is currently in double digits and has a high weight in consumer prices. In May, the India Meteorological Department reiterated its normal monsoon forecast. So, assuming a normal monsoon, we expect food inflation to soften.

That said, what matters for agriculture and food inflation is not just the amount of rainfall, but also its distribution over time and geography. Clarity on this aspect will emerge with the progress of the monsoon.

It would be the fifth successive normal monsoon — if it does turn out to be one. That is a rarity. With climate change at play, monsoons can always throw a curveball. Plus, the Australian Bureau of Meteorology recently elevated the El Nino watch to the "alert" category, indicating a 70 per cent chance of El Nino this year. Fingers crossed, therefore.

Fuel inflation is already heading down and will come down further as global crude prices will be lower compared with last fiscal. We expect the per-barrel brent price at $80-85 this fiscal year compared to $95 in the previous one.

Core inflation, obtained by excluding fuel and food from the overall CPI basket, has been the sticker part of inflation, not only in the last fiscal but also in the past. Slowing domestic demand and lower input prices will help tame it a bit.

Another interesting feature of inflation dynamics is the goods versus services inflation. Goods inflation has corrected more than services inflation. Historically, service inflation has been higher than goods inflation. During the pandemic, due to reduced demand for services, its inflation stayed lower than goods inflation, which had spiked due to the supply shock amid continued demand for manufacturing products. That is correcting.

Demand for services such as airlines and hospitality has turned fast and furious with the withdrawal of Covid-induced restrictions and this is pushing up their prices. Concomitantly, the correction of commodity prices has dragged WPI into deflation territory and will help soften consumer price inflation with a lag.

For 2023-24, RBI has maintained its growth forecast of 6.5 per cent and cut its inflation forecast. Growth for 2022-23 was revised up by the National Statistical Office recently to 7.2 per cent from 7 per cent. The momentum for the first quarter of the current fiscal so far is quite healthy, as expected by the RBI, which has forecast a 8 per cent growth for the quarter.

As per S&P Global's Purchasing Manager Index (PMI), both manufacturing and services remained robust in the first two months of this quarter. Between April and May, the manufacturing PMI rose from 57.2 to 58.7, while for services, it was above 60 in both months.

The numbers for 2022-23 show consumption and investment activity were quite robust, outpacing overall GDP growth. While investment remained strong for all four quarters of last year, private consumption slowed down towards the second half. We expect investment momentum to continue this fiscal and private consumption to be a tad slower compared to last year.

On the whole, we expect growth to slow to 6 per cent this fiscal as global economic activity decelerates in the second half of 2023 — after a better-than-anticipated showing in the past few months — and the lagged impact repo rate hikes show up. Consequently, merchandise exports, which have been already slipping, will decline more as growth in the West, India's major export market, unravels. On the other hand, China is growing but that does not help much — they account for less than 5 per cent of our total exports.

Housing and auto loans have already risen past pre-pandemic levels and given that some transmission of the rate hikes is yet to play out, activity would moderate down the road. With consumer inflation in the first quarter set to print lower than its forecast of 5.1 per cent, there is little surprise the RBI cut the inflation forecast to 5.1 per cent from 5.2 per cent for the full fiscal. As for agriculture output and prices, the eyes are riveted on the monsoon.

Recent Monetary Policy Review of RBI

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) presented the bi-monthly monetary policy review on June 8. This was the second bi-monthly monetary policy meeting for the financial year 2023-24 which began on June 6 and ended on June 8.

Key Points of Monetary Policy Review:

- On the basis of an assessment of the current and evolving macroeconomic situation, RBI decided to keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50%.
- The standing deposit facility (SDF) rate remains unchanged at 6.25% and the marginal standing facility (MSF) rate and the Bank Rate at 6.75%.
- These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2%, while supporting growth.

What indications are considered the basis behind the present review?

- Wheat prices could see some correction on robust mandi arrivals and procurement.
- The forecast of a normal south-west monsoon by the India Meteorological Department (IMD) augurs well for kharif crops; however, the spatial and temporal distribution of the monsoon would need to be closely monitored to assess the prospects for agricultural production.
- Crude oil prices have eased but the outlook remains uncertain.

Expected Question

Que. With reference to the recent monetary policy review of RBI, consider the following statements:

1. It was the second bi-monthly monetary policy meeting for the financial year 2023-24
2. Under this, it was decided to keep the policy repo rate unchanged at 6.50%.
3. The Bank Rate remains unchanged at 6.75%.

How many of the above statements is/are correct?

(a) Only 1

(b) Only 2

(c) 1, 2 and 3

(d) None

Answer : c

Mains Expected Question & Format

Que.: 'Discuss the current monetary policy of the Reserve Bank of India and what signals the recent monetary policy of RBI gives in the context of the Indian economy? Comment. (250 words)

Answer Format :

- Discuss the recent monetary policy reviews of RBI at the beginning of the answer.
- The next part of the answer is to discuss the signals and conclusions that we are getting from the monetary policy reviews of RBI.
- Finally give a brief conclusion.

Note: - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC mains examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.