INTERVIEW

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Inflation Targeting: Options before the Central Bank

India's core inflation continues to be way above RBI's comfort zone. A widely-held view is that core inflation even over a longer period such as a decade has sustained around 5% and above, notwithstanding periods of economic sluggishness in between. Commodity prices have come down a bit, but they remain at elevated levels, given the ongoing Russia-Ukraine war and the rising tensions in Taiwan Straits. India's food grain stockpile is already at a five-year low. So, what lies in store as far as inflation is concerned and if the central bank resorts to more rate hikes in its forthcoming MPC meetings? Also, what will be the impact of the US Fed's actions on the domestic inflation scenario, especially in the context of India's rising oil and food import bill? **N Janardhan Rao, Deputy Editor**, *The Global ANALYST*, invited **Rajani Sinha, Chief Economist, CARE Ratings Ltd., Mumbai** to share her views on the present inflationary environment in the country and a range of other issues.

RAJANI SINHA

CHIEF ECONOMIST, CARE RATINGS

■ Core inflation continues to be way above RBI's comfort zone. Given that, what options does it have now to bring headline retail inflation within the targeted 2-6% band?

As per our estimates, core inflation in the last few months has moved within the RBI's target band, though it is still close to the upper end of the band. The central bank has already been taking measures to reduce inflationary expectations by front-loading policy interest rate hikes and reducing liquidity in the system as required. Inflation controlling measures taken by the government/RBI and the reduction in global commodity prices has helped reduce CPI inflation in the last few months.

However, global commodity prices are still at elevated levels. Fear of global recession has resulted in a fall in commodity prices in the last few months. But given that the global supply bottlenecks are still prevailing, it is difficult to predict the future trajectory of the global commodity prices. In the given scenario, RBI and the government would remain cautious and take future actions depending on the evolving domestic and global economic scenario.

■ A widely held view is that core inflation even over a longer period such as a decade has sustained around 5% and above, notwithstanding periods of economic sluggishness in between. Hence, can it be concluded that it will remain the stickiest part of retail inflation and thus dash any hopes of headline inflation providing succor anytime soon?

The critical factor that had pushed up India's retail inflation strongly in the last few months has been the high global commodity prices. While inflationary pressure started from high global commodity prices, it gradually became broad-based resulting in all components of inflation, including the core, rising sharply. While the inflation pressure has been mainly because of supply-side factors, with economic recovery gathering pace the demand-side is also gathering strength. Core inflation generally tends to be sticky. But the demand-side pressure on inflation is still not very strong as economic revival is still at a nascent stage. Hence, if there is a further correction in global commodity prices on recessionary fears, it will provide further respite to domestic headline inflation.

■ Commodity prices have come down a bit, although they remain at elevated levels, given the ongoing Russia-Ukraine war and the rising tensions in Taiwan Straits. Meanwhile, some reports even suggest that India's food grain stockpile is already at a five-year low. Given that, what is your outlook on inflation in the medium to short term?

While the global commodity prices are still elevated, the fall in prices in the last two months have brought much respite to domestic inflation. The measures announced by the government in the form of duty cuts on some imports, export restrictions for some items and an excise duty cut for petrol/diesel have also helped ease inflationary pressure in the economy.

Having said that there are lingering concerns. Global supply constraints continue, implying that there is still uncertainty on the likely trajectory of global commodity prices. On the domestic front, while the overall monsoon has been above normal, the rainfall has been deficient in some regions which has impacted Kharif sowing especially of paddy. Strong heat waves during summer has already led to lower-than-expected wheat output. In such a scenario, there is a need to still be cautious on the inflation front.

However, with inflation easing in the last few months, the concern has somewhat ebbed. We expect CPI inflation to ease below 6% by the last quarter of FY23. On the back of two years of high inflation, we expect CPI inflation in FY24 to average around 5%, assuming no major supply bottlenecks.

■ Do you see the central bank resorting to more rate hikes in its forthcoming MPC meetings?

Global commodity prices are still elevated, and CPI inflation remains above RBI's target band. Given the continuing global uncertainties, RBI would remain cautious. We expect RBI to hike the policy repo rate further in the forthcoming meetings. External sector dynamics could also have a bearing on RBI's decision, given that the US Federal Reserve is likely to hike rates further. Moreover, with domestic growth showing signs of improving, RBI would like to take this opportunity to move towards a positive real rate of interest. We expect a further 50 bps rate hike, which will take the terminal repo rate to 5.9% by the end of the current fiscal year, that is, FY23.

■ What impact do you foresee of the US Fed's actions on the domestic inflation scenario, especially in the context of rising oil and food import costs?

With inflation in the US much above the target, the US Federal Reserve is expected to continue with rate hikes. Coming in the backdrop of slowing growth, this has aggravated fears of a recession in the US economy. The global commodity prices have fallen on fear of global recession and that is a big reprieve for domestic inflation. But at the same time, the Fed rate hikes have resulted in the US dollar strengthening and consequent weakening of INR. This in turn is resulting in imported inflation into the Indian economy.

■ When do you see both inflation measures, that is, WPI and CPI, finally falling in line?

The increase in WPI inflation had been relatively more than CPI due to the difference in composition of both indices. WPI has a higher weightage of manufactured goods and fuel, whereas CPI has a higher weightage of food components. Another reason why WPI inflation has been higher is that the producers were not able to pass on all the input price increases to the consumers, due to weak demand.

Both the measures of inflation have been inching down supported by falling global commodity prices and measures taken by the government and RBI. While the fall in global commodity prices have provided a big reprieve, we must be cautious given that the global supply concerns persist. We expect CPI and WPI inflation to fall below 6% by the end of FY23.

■ What are the other challenges you see before the central bank?

With global growth slowing and central banks continuing to hike policy rates, the external environment is getting volatile and uncertain. Managing India's external sector dynamics and consequent volatility in the financial markets will be another challenge for the central bank. With US Federal Reserve likely to continue with rate hikes and the dollar index continuing to strengthen there will be weakening pressure on INR. The weakening pressure would be further aggravated by the worsening of India's external balance. India's current account deficit is expected to widen to 3.1% of GDP, and with capital flows reducing, the BoP is likely to move to a deficit zone in FY23. So, managing the forex market volatility while ensuring not a sharp depletion in forex reserves would be a challenge for the central bank.

■ Another view doing the rounds is that unless the policymakers address inefficiencies in areas such as factor markets, like land and labor, it would be tough to bring down inflation to the desired level anytime soon. The concern stems from the fact that with large firms still being able to pass on input cost rises to consumers, the cost pressures will continue to exist and this, in turn, would support an inflationary environment. What is your opinion?

With demand rising, weak firms were reluctant to pass on the input price increases to consumers. This is expected to put pressure on inflation. However, it is to be noted that the sharp rise in inflation that we have seen in the last couple of years is mainly because of the supply-side factors. There were supply bottlenecks induced by the Covid pandemic that has been further aggravated by the Russia-Ukraine war. While the demand side pressure is gathering strength with the economic recovery, it is still not very strong. Hence, once the supply-side bottlenecks are taken care of globally, domestic inflation will ease.

Over a longer period, factor market inefficiencies will keep inflation in India relatively high. Given the challenges in land acquisition, land cost is still very high in India and even with abundant labor availability, adequate skilling is a concern area. These are long-term challenges in bringing down domestic inflation.

■ Seen against this backdrop, do you see the repo rate hitting the 6%-mark by the end of this fiscal year amidst widening trade deficit and an anemic rupee?

We expect the repo rate to rise to 5.9% by the end of this fiscal year. Apart from controlling inflation, the weakening rupee is another factor putting pressure on RBI to hike interest rates. More importantly, with growth improving RBI would like to take this opportunity to move towards a positive real rate of interest.

■ What is your overall outlook on the economy?

Liquidity management would be the other critical issue for the central bank. The central bank wants abundant liquidity from the system to reduce to make the policy rate hike effective. It would need to ensure sufficient liquidity to not disrupt the government's huge borrowing program and also not crowd out the private sector's credit requirement. ■

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