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For RBI, the growth vs inflation dilemma continues

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With global commodity prices broadly easing in the last three months or so and with CPI inflation inching down from May-July, there was some sense of reprieve in the markets. However, the August CPI inflation again flared up to 7 per cent, more than market expectations.

To make RBI's task more challenging, the GDP growth for Q1 FY23 and the latest IIP data for July, came lower than market expectations, reiterating the persistence of growth concerns. So, the upcoming meeting of RBI's MPC (Monetary Policy Committee) will be in a backdrop of higher-than-expected increase in inflation and lower than expected economic growth.

Many of the developed economies are also in the same boat, recording higher than expected inflation (even with the fall in gasoline prices) and weaker growth indicators.

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Let's dig little deeper into the latest domestic inflation data. The rise in inflation in August was mainly because of food inflation that shot up to 7.6 per cent in August from 6.7 per cent in July. On sequential basis (MoM), there was a sharp increase in prices of cereals, vegetables, milk and pulses. Given the uneven distribution of rainfall, we are seeing a price increase in many of these food items. So even while there has been a broad fall in some global commodity prices in the last few months, domestic food inflation has re-surfaced.

ALL EYES On the MPC meet REUTERS

Moreover, the core inflation (excluding food and fuel) remained high at around 6 per cent in August, highlighting the deep penetration of inflation in the economy. While demand-side inflation in India is still moderate, there is risk of demand-side inflation strengthening as the economy gathers momentum.

India's growth is on an improving trajectory, albeit at a slower than expected pace. Domestic consumption and investment indicators are showing gradual improvement. Private consumption and investment expenditure in Q1 FY23 GDP grew by 9.9 per cent and 6.7 per cent respectively when compared with the pre-pandemic period of Q1 FY20. Some of the other high frequency economic indicators like e-way bill collection, GST revenue, auto sales, PMI continue to show improvement. While manufacturing showed a sharp sequential contraction (qoq) in Q1 FY23, its outlook will improve with the easing of raw material prices. Even with the pent-up demand, some of the service sectors have not yet reached the pre-pandemic period.

Specifically worrying is the Q1 FY23 GDP data on Trade, Hotel, Transport and Communication, that contracted by around 16 per cent when compared with Q1 FY20.

Apart from domestic challenges, the big concern is on external front. With global growth slowing, India's exports are feeling the pinch. Net exports sharply pulled down the GDP in Q1 FY23 and is likely to widen the CAD to more than 3.5 per cent of GDP in FY23. So, overall while the economy is recovering, it is mired by various challenges.

Given the high inflation, RBI is likely to remain cautious and hike the repo rate by another 50 bps in the upcoming meeting. This will also be in line with rate hikes in developed economies.

The moot question then is at what level will RBI stop the rate hiking cycle. If sequential inflationary pressure persists, the terminal repo rate could be higher at around 6.25-6.5 per cent. The other critical focus area would be liquidity management as the central bank would like to ensure ample liquidity to support growing credit demand.

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