The Indian Growth-Inflation Dilemma in the Face of Rising Geopolitical Unrest

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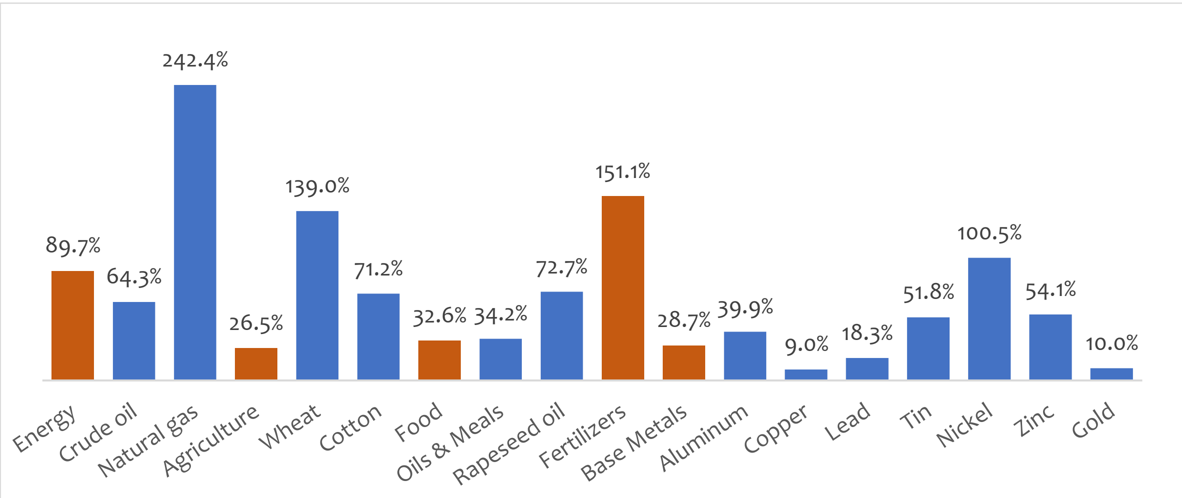
Price control weigh over nurturing growth

The global economic and financial environment has been worsening since the escalation of geopolitical strife and the associated sanctions. The disrupted supply chain pressures, which were set to ease post-covid, have resurfaced. Commodity price increase have exacerbated inflationary pressures in both advanced and developing market countries (EMEs). The headline CPI inflation in the United States, Eurozone and UK are nearly four times higher than their targets. Recognizing that inflation is no longer a transient phenomenon, the Fed along with other central banks have preferred aggressive normalisation of monetary policy.

Shocks to the international commodity and energy prices have had a substantial spill over effects on India through multiple channels. Firstly, the worsened supply chain disruptions resulting in cost-push inflation which is durable in nature. Secondly, purchasing power is eroded and economic activity is slowing down. Thirdly, loss in export competitiveness is widening current account deficit (CAD). The negative real interest rate has touched new peak (CPI: 7.79% - Repo: 4.4%= -3.39%) and distorts domestic savings. Because fiscal policies have limited capacity to absorb the pass-through effect of imported inflation, capital investment may take a hit and the twin deficits persists for a foreseeable future.

Table 1: Year on Year growth in commodity prices (%) : April 2022



Source: World Bank Commodity Price Data (The Pink Sheet)

RBI and Inflation Management

Until recently the RBI believed inflation was a transient phenomenon. However, the extended Russia-Ukraine conflict and the volatility in global commodity prices as a result of sanctions, have convinced the RBI that inflation is no longer transient. As the economy continues to recover, damage to the global supply chain and geopolitical upheaval have resulted in price increases, which are mostly characterised as cost-push inflation. Domestically, private consumption and investment remain sluggish, and contact-based services, while improving, have yet to be fully recovered.

The situation has been challenging for net oil importers such as India (which imports about 80% of its energy requirements from global market) since the economic recovery from the pandemic remains incomplete, even as inflation continues its march. The retail and wholesale inflation for April reached 7.79% and 15.1%, respectively, recording multiyear highs. While RBI has revised its inflation forecast for FY23 to 5.7% from 4.5%, FY23 growth forecast is trimmed to 7.2% from earlier projection of 7.8%. Considerable forecast error (120bps deviation in inflation and 60bps in growth projections) in the RBI's forecast highlights the magnitude of uncertainties and the difficult trade-off between containing inflation and nurturing growth for the central bank.

In an surprise off-cycle meet, the RBI's monetary policy committee (MPC) raised the policy repo rate by 40bps to 4.4% in a unanimous vote on May 4th citing continued inflationary pressures in the economy. The RBI also increased the Cash Reserve Ratio (CRR) by 50bps to 4.50%, which would take effect on May 21 and remove about Rs. 850 billion of liquidity from the market (average liquidity in the system as of April 2022 stood at Rs. 7.4 trillion). This is the first hike in repo rate by the RBI since August 2018. This move was made in response to increased uncertainty in the global macro backdrop, and the RBI has clarified that the central bank's stance and policy conditions remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth. Following a prolonged period of accommodating monetary policy (from February 2019), the RBI is suddenly concerned about inflation. In its last MPC (April 8), the RBI sent several hawkish signals to the market by normalising the policy corridor (LAF) to pre-pandemic levels (50bps). In its May policy decision (3-4), the FOMC tightened policy further by raising the fed funds rate by 50bps to 0.75% - 1.00% range and launched quantitative tightening (QT) on expected lines with initial pace of QT to the tune of USD 47.5bn over June-August, which will be increased to USD 95bn from September onwards. Fed has emphasized that the focus is now on tackle the ongoing inflation risk.

Fragile macro sentiments and risks of Inflation

According to the second advance estimate of the National Statistical Office (NSO), Indian economy registered a growth of 8.9% in FY22, rebounding from its contraction of 6.6% in FY21. The pace of economic recovery has been slowing down in last few months attributed more towards global factors. Cost pressures from increasing energy and raw material prices, followed by a drop in demand in anticipation of a new covid type, are preventing producers from operating at full capacity. The current enterprise survey (March 2022) reflects input cost constraints, notably in the services and infrastructure sectors, while firms are less confident about overall business conditions. The manufacturers' capacity to pass on cost constraints is limited due to the uncertain demand circumstances. The 731bps wedge between wholesale (15.1%) and retail Inflation (7.79%) shows the lack of pricing power among producers. Inflation expectations among households have also remained strong.

In contrast to industrialised countries such as the United States and the United Kingdom, where a positive production gap and a tight labour market sustain significant inflationary pressures, India's output gap remains negative. While a wider inflation gap and a positive production gap justify aggressive tightening by the Fed and the BoE, India's circumstance does not require a faster winding down of accommodating monetary policies. Since 2019, the RBI has favoured growth above inflation through ultra-accommodative monetary policy, with the goal of eradicating transitory inflation at some point in the future. However, the extended geopolitical crisis and supply chain interruptions have been a stumbling block, and the worst part is that the economic impact of the sanctions would remain longer even if a swift ceasefire is reached.

Policy Dilemma: Growth (employment) vs. Inflation

Globally, central banks have handled cost-push inflation with caution. Because cost-push shocks cause both an increase in inflation and a negative output gap, which is recessionary, the ideal central bank reaction is extremely debatable. According to Baeriswyl and Cornand (2010), when the uncertainty around its monetary instrument is large, a credible central bank may find it desirable to execute an accommodating monetary policy in response to a positive cost-push shock. Central banks have historically found it difficult to manage cost-push inflation using monetary policy instruments since higher interest rates are likely to exacerbate the problem of recession. The Hicks–Hansen model (IS-LM model) depicts the problems that monetary authorities confront in dealing with cost push inflation, which causes the short-run aggregate supply curve to shift to the left, resulting into higher inflation, but also lower economic growth. Fiscal policies, sometimes known as supply-side policies, are best suited.

Many nations experienced substantial positive cost-push shocks throughout the 1970s when the price of oil climbed dramatically. In reaction to these oil shocks, the Fed loosened monetary policy. Similarly, following the Lehman crisis, there was indications of cost push inflation in the UK where the BoE cut interest rates by 50bps in March 2009 and has maintained them low since 2013. It permitted inflation to stay high, assuming that cost-push inflation would be transient rather than permanent. The nature of a cost-push shock presents a quandary for the RBI. It may either loosen its monetary policy to protect the negative production gap or tighten it to combat the inflationary rise (which may be futile).

Optimal policy solutions to check price with supporting growth

To alleviate the cost-push price spiral, a combination of deflationary monetary policy and supply-side initiatives may have some impact, but with a significant time lag. The monetary policy's poor efficacy in tackling cost-push inflation is clearly explained through the interest rate-investment and trade channels. Monetary tightening leads to increased interest rates, which raises the cost of borrowing and discourages consumer spending and investment. On the other side, rising interest rates tend to promote a rise in the home exchange rate, placing downward pressure on imported products and limiting the passthrough of higher international prices to the domestic economy. These policies minimise inflation, but at the expense of diminished economic activity and increased unemployment. As a result, adopting demand-side measures (monetary instruments) to stop a cost-push price spiral can do considerable harm to the economy and lead to a recession with rising unemployment, a condition known as stagflation.

Solutions in containing price spiral

Understanding the origins of cost push inflation makes it easier for policymakers to address the issue. Today, inflation is a by-product of a) rising energy prices, b) oil/gas shortages due to the Russia-Ukraine conflict, c) rising shipping costs due to congestion at Chinese ports and lockdowns, d) rising commodity prices, e) bottlenecks in global supply chains due to pent-up demand following the end of Covid lockdowns, f) tightening labour market, g) wage inflation, and so on. Unlike monetary policy, there are several approaches to cost-push inflation. Each supply-side issue must be addressed in its own distinctive way.

According to research, a 10% increase in petrol and diesel prices directly leads to a 22bps increase in CPI inflation in India, while a 10% increase in kerosene and LPG prices has a 26bps influence on CPI inflation. Assuming a 50% pass-through of input prices to end consumers, the second order effects of higher transportation costs lead to an additional 31bps rise in inflation, bringing the total impact to 79bps. Sticky local crude oil prices in the preceding two years have prevented domestic customers from reaping the advantages of falling international crude oil prices. As other sources of money dried up, the government was able to fund additional pandemic-related expenses through greater tax collection.

Both direct and indirect taxes are robust today, giving the government adequate leeway to reduce fuel taxes, including excise duty and VAT, in order to alleviate the pass-through of foreign prices to consumers. However, a significant trade-off must be addressed between greater inflation and its consequences for consumption and the government's budget deficit and of borrowings. As a short-term remedy, lowering excise tax and VAT may significantly help to alleviate inflationary pressures. Longer-term investments in alternative energy sources, better diversity of energy sources, strategic stockpiling etc. will assist to mitigate the economic impact of energy price shocks.

The second most important cause is transport bottlenecks mainly shipping. Because this is primarily a worldwide problem, the government's options for dealing with it are limited but easing the inter-state road and rail transportation delays may help considerably. In the long run, the government may spend more in road, rail, freight, and marine infrastructure to improve supply chain and logistics flow.

The third most crucial aspect to consider is a price ceiling to prevent price monopoly and rationing. Monopolies exploit their market power to raise prices and worsen the situation when there is a supply shortage. Price limits imposed by the government might curb price rises. One of the most critical procedures is to keep an eye out for unlawful stockpiling of pulses, grains, and edible oils. In line with the government's action in 2021, which reduced customs duty and agricultural subsidies on crude edible oils, a similar action across a wide range of commodities is desired. Immediate diversification of import partners is not an ideal solution when the global economy is struggling with a tight supply chain.

In a nutshell, both fiscal and monetary policy must use the available room to smooth out international shocks. Gradual withdrawal of accommodating policies by raising real rates to a neutral level is unlikely to impair economic activity and is compatible with non-inflationary growth.

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