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RBI targets inflation

By Kunal Kumar Kundu

In its mid-quarterly monetary policy review announced on Thursday, the Reserve Bank of India (RBI), on the basis of its assessment of the current macroeconomic environment, made the following announcement: It would:

- Would increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.5% to 6.75% with immediate effect; and

- Increase the reverse repo rate under the LAF by 25 basis points from 5.5% to 5.75% with immediate effect.

It has, however, kept the cash reserve ratio (CRR), the proportion of deposits banks have to keep in reserve, unchanged at 6%.

To me, an interesting part of the statement is the acceptance that the inflation for the current financial year (April '10 - March '11) will be higher than previously anticipated. It would be useful to remember that in my Asia Times Online article dated January 27 RBI falling behind the inflation curve, I insisted that RBI has been under-estimating the inflation numbers for India.

In the recent review, the central bank's estimate of inflation for end March 2011 has been increased from 7% to 8%. Rarely has one seen inflation estimate for a particular period going up by as much as 100 basis points within less than two months. And that too by a central bank.

To a certain extent, I sympathize with the RBI. In the same statement, RBI talked about fears of inflation emanating from narrowing output gap. I have been maintaining that India is a supply constrained economy and any endeavor to jack up growth rates would lead to building up of inflationary pressure. In essence, what is required is to continue with structural reforms, invest more in agriculture and physical infrastructure, remove roadblocks and reduce leakages that put pressure on deficits.

Unfortunately, while the solutions are known, not much headway is made in these regard leaving RBI to use monetary policy as the only instrument to fight inflation. Problem is, squeezing credit availability or raising interest comes at the cost of growth, leaving RBI to try and bring about a fine balance between growth and inflation. This becomes more problematic in a situation when there's more than enough uncertainty about global growth prospects.

With many European countries embarking on strict austerity measures, European growth is expected to suffer this year. In addition, they are facing inflationary pressures. Official data published recently showed that the annualized euro zone inflation reached 2.4% in January, the highest for more than two years. More importantly, this was quite beyond the European Central Bank (ECB) target inflation rate of 2% at the most.

Germany is also experiencing the inflationary pressure. Its January 11 Consumer Price Index rose to 1.96% from 1.67% in December 10. With robust economic recovery, there is a fear of a wage-price spiral. Recently, Volkswagen and German unions agreed to a pay increase of 3.2%. This raises the prospect of other sectors following suit, which can push up inflation to a much higher level. That there will be further pressure on consumer inflation is also clear from that fact that German producer prices rose 5.7% year on year in January - the strongest rise since October 2008.

In the UK, the Consumer Price Index rose from 3.7% in December to 4% in January. Even core inflation inched up to 3%. This is the highest rate since late 2008, when record oil prices caused inflation to spike higher. Even the current spurt in the inflation rate can, to a large extent, be attributed to oil prices coupled with higher food prices and the depreciation of the British pound, which has increased the cost of imports.

While the increase in VAT can be partially blamed for increasing inflation, it is clear that existence of spare capacity in the economy and high unemployment levels have failed to tame inflation. Essentially, despite existence of adequate output gap, Europe is facing inflationary pressures. For the ECB, inflation beyond the threshold is like a red flag to a bull. If the ECB decides to raise interests rate to fight inflation, European growth is expected to suffer from the impact of a double whammy brought about by a contracting government sector (through austerity measures) and rising interest rates.

Even in the case of the US, although some recent data shows signs of strength (purely on the back humongous levels of stimulus), the problems for the economy are far from over. Inflation is yet to become a major problem there - the headline rate rose only to 1.6% year on year (0.4% month on month) in January 11, below target. But it is important to note that even this growth has outpaced growth in wage rates. In fact, unit labor cost, which is used as a proxy for the wage rate, continues to contract, although the pace of contraction is less now.

Rising inflation can be partly explained by the massive balance sheet expansion that the Federal Reserve undertook in its effort to stimulate the US economy. As base money supply increased, risk aversion by the banks prevented them from lending. A high level of joblessness and concern about growth prospects resulted in tight-fisted consumers. In essence, the increased money supply did not enter the real economy but sought refuge in emerging market equities and more importantly in commodities, which emerged as a much sought after an alternate asset class, leading to asset inflation. Rising commodity prices and large inflows of foreign funds have been a major cause for sharply rising inflation and currency appreciation in emerging markets.

Now, high inflation in the emerging economies is being transmitted back to the developed economies through the trade channel. When China emerged as the poster boy of global manufacturing outsourcing with its eye-popping growth and benign inflation, many global manufacturers set up their production base there and in other low cost emerging-country locations.

As long as inflation in China remained under control, everybody was happy. Now China and other emerging economies are experiencing a sharp spurt in inflation but the dependence of the developed economies for their manufactured products on the less-developed countries continues, given the shift in the manufacturing base. As a result, the emerging economies are now exporting their inflation. This is clearly evident from a sharp rise in the import price index of the US and the euro area.

Despite the existing slack in the economy, the US is experiencing cost push inflation, especially if some survey results are to be believed. The National Federation of Independent Businesses' Small Business Optimism Index showed that the percentages of respondents raising average selling prices continued to gain ground in January. In addition, January's Morgan Stanley Business Conditions Index yielded a new 31-month high in the number of survey participants whose firms had charged higher prices relative to a year ago.

This is not a surprise and momentum is likely to increase, since the Producer Price Index, which tracks the price manufacturers are paying for producing goods, rose by as much as 3.7% year on year (or 0.8% month on month) in January. This glaring difference between producer cost inflation and consumer inflation can't last forever and rising costs for US producers will come back to bite US consumers one way or another.

As inflation rises, interest rates would also need to rise. With the US debt/GDP ratio expected to touch 100% by 2011, increasing interest rates would put tremendous pressure on the government looking to finance its expenditures and service its debt.

Recently, PIMCO, the world's largest bond fund, became bearish on the prospects of the United States, going to the extent of selling all of its US government-related debt holdings. Bill Gross' US$236.9 billion PIMCO Total Return fund sold of its entire holding in the US treasuries as they were clearly bearish on the burgeoning deficit of the US and its inflationary impact. What this indicates is that the yield expectations are rising and going forward, and the government would need to increase interest rates to be able to attract investors to its T-bills. With debt levels soaring, rising interest rates will be debilitating for the prospects of the US economy.

Unlike Europe, the US does not seem to believe in austerity measures. And with the country building up on debts when interest rates were at its lowest, it is only a matter of time before the situation will deteriorate as interest rates bottom out and start moving up.

With such an uncertain global environment, therefore, it is not surprising that the RBI is as much concerned about inflation than it is about the growth prospects. Hence the calibrated approach. Also, with oil on the boil, inflation will continue to haunt the Indian economy. I expect the RBI to go for another couple of rounds of rate hikes (of 25 basis points each) before pausing for some time to take stock of the situation.

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