KERALA ECONOMY
2023, VOL. 4, NO.4. pp 101-110.

ISSN : 2583-4436

GIFT GULATI INSTITUTE OF FINANCE AND TAXATION

Global rate hike cycle nearing an end: Decoding India's distinct trajectory and its implications

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Introduction

The Federal Reserve's recent signals of potential rate cuts in the current year have triggered a global shift in monetary policy. During its December policy meeting, the Fed suggested a prospective reduction of 75 basis points in the fund rates for the ongoing calendar year. This indication is catalyzing central banks worldwide to adopt a more accommodative stance in their monetary policies. The articulated dovish stance is attributed to a deceleration in economic growth and efforts to mitigate inflationary pressures. At present, the US Federal Reserve's funds rate stands between 5.25% and 5.50%, reflecting the current monetary landscape. The acknowledgment of subdued economic activities and a measured approach to curbing inflation underscores the rationale behind the signaled shift in policy direction.

According to Bloomberg data from the 2024 Policy Rates Report, there has been a notable decline of 128 basis points in key policy rates globally. Emerging Market Economies (EMEs) are at the forefront of this trend, leading the way in implementing significant reductions in their key policy rates. The data underscores a widespread adjustment in global monetary policies, particularly evident in the policies adopted by emerging economies. For instance, with countries like Brazil and the Czech Republic already initiating the process of reducing key policy rates. In tandem, other Emerging Market Economy (EME) central banks, including Argentina and Russia, are poised to embrace a dovish stance, planning to implement more substantial rate cuts. Moreover, central banks such as the European Central Bank and the Bank of England are expected to follow suit shortly, signifying a broader trend toward monetary easing on the global stage.

Many central banks are contemplating the initiation of an interest rate easing cycle due to the demonstrated limitations or constraints of interest rates as an effective monetary policy tool in alleviating post-pandemic inflationary pressures. The multifaceted sources of inflation have rendered traditional monetary tools less effective in mitigating price pressures. Consequently, central banks are opting to conclude the interest rate hiking cycle. However, a stark contrast emerges when examining Asian economies in this context. The approach and response of central banks in the region differ significantly, suggesting unique considerations at play within the Asian economic landscape.

Table 1: Interest rate and inflation of major central banks vis-à-vis India (In percentage)

Central Banks	Policy Rates	Last Policy Action	Date of Last Change	Latest Inflation
Federal Reserve	5.25-5.50	↑ 0.25	Aug-23	↑ 3.4
European Central Bank	↑ 4.5	↑ 0.25	Sep-23	↑ 2.9
Bank of England	↑ 5.25	↑ 0.25	Aug-23	↓ 3.9
Bank of Japan	↓ -0.1	↓ -0.2	Jan-16	↓ 2.6
Reserve Bank of India	↑ 6.5	↑ 0.5	Dec-22	↑ 5.7

Source: Respective Central Banks

Notes: Last policy actions are bps; Policy and inflation rates are in percentage

India's distinct path of interest rate decisions

In its December Bi-monthly policy, RBI kept the repo rate unchanged at 6.5 percent and kept the stance – "withdrawal of accommodation" intact. RBI is emphatic about bringing down the inflation on a durable basis to 4 percent and maintaining the system liquidity in tandem with the policy stance. It underscores RBI's constant vigil on disinflationary measures even amidst plunging core inflation. The persistent food inflation and factors driving the food prices remain a serious concern for the central bank. However, a dovish tilt is implicitly reflected in the remark on the risk of overtightening policy rates. Hence, considering the potential upward risks arising from high food prices that impact overall inflation, India might not be able to emulate advanced economies in adopting a more accommodative stance any time soon.

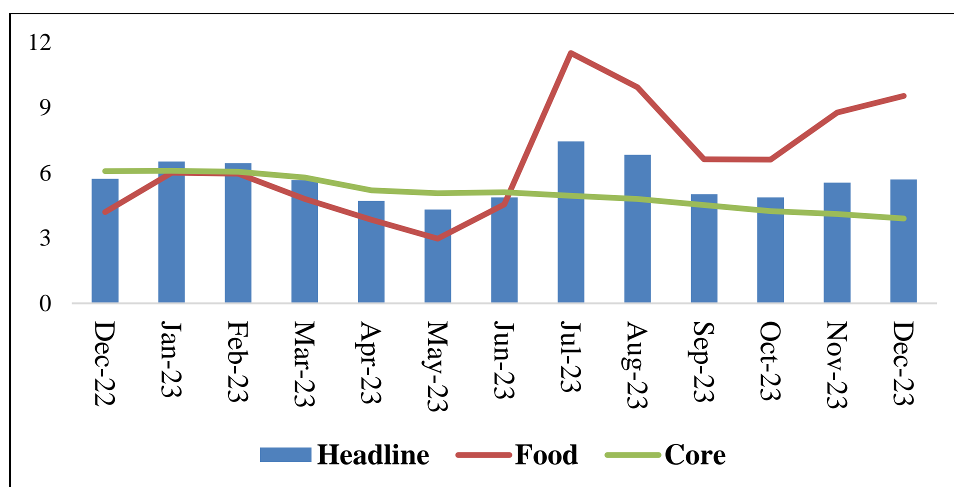
Inflation concerns at the forefront

The primary challenge of achieving the inflation target emanates from the volatility in food prices. Since the wake of the pandemic and Ukranian geopolitical tensions, food prices have been on the rise contributing to headline inflation. Commonly acknowledged as transient, these shocks seem to have introduced both volatility and persistence to food inflation, which averaged 6.7 percent from April 2022 to November 2023. Notably, food carries a substantial weight of 45.9 percent in the consumer price index (CPI). However, its contribution to overall inflation has escalated from 48 percent in April 2022 to 67 percent in November 2023.

The prolonged food inflation poses a genuine concern and presents a challenge for policymakers. According to the most recent data on December's inflation, the combination of elevated food prices and an unfavorable baseline propelled headline inflation to a four-month peak of 5.7 percent. In contrast, core inflation remained relatively subdued at 3.90 percent. Specifically, within the food category, the persistent inflationary pattern observed in non-perishable items like cereals, pulses, and spices raises apprehensions about their future price trajectory, considering their inherent resistance to price adjustments. For perishable categories, particularly fruits and vegetables, inflation persisted at double-digit levels, with growth rates recorded at 11.1% for fruits and 27.6% for vegetables, respectively. Anticipated reductions in Kharif production, coupled with uncertainties surrounding Rabi sowing, are heightening concerns on the supply side of the food basket. The latest data indicates a decrease of approximately 4.7% in Rabi sowing, primarily driven by a notable decline in the cultivation of cereals and pulses, attributed in part to lower reservoir levels. The upcoming new-season cereal crops are expected to arrive only from April onwards, potentially keeping cereal prices robust in the near term. The outlook for pulses is also bleak, as the projection of diminished Kharif output, combined with delayed Rabi sowing of pulses, further exacerbates concerns. Consequently, timely interventions on the supply side by the government are crucial to effectively curb inflationary pressures within the food basket.

Given its substantial share in the consumption basket, food inflation possesses the capacity to impact both headline inflation and, in the occurrence of significant and recurrent food price shocks, non-food inflation as well. Therefore, volatility in food prices remains a matter of concern while projecting the future course of inflation.

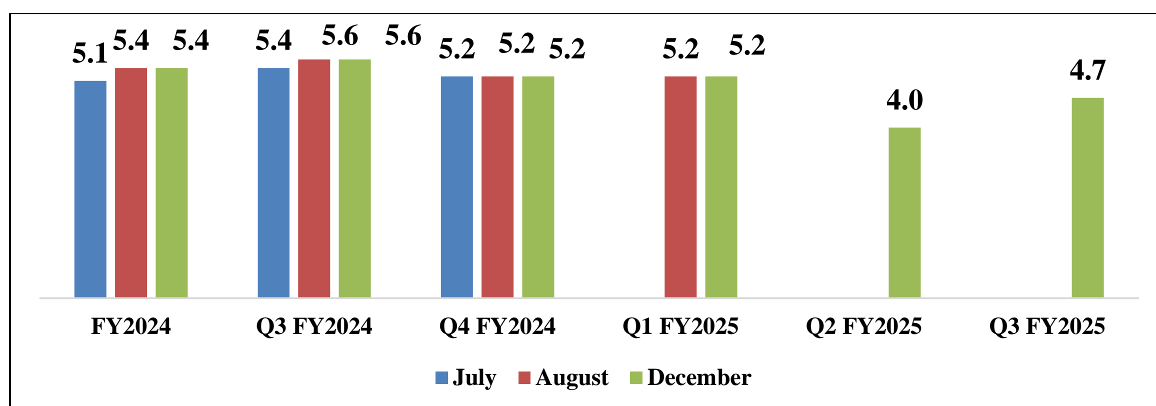
Figure 1: Headline inflation pushed up by food prices



Source: MOSPI

In December 2023 policy update, the RBI has kept its headline inflation projections steady at 5.4 percent for the Financial Year 2024, above the target level. The outlook is marked by the unpredictable path of food inflation, with lingering price pressures on specific items like onions, potatoes, pulses, and wheat. Additional concerns arise from the uneven progress of Rabi sowing due to irregular monsoon patterns and the surge in global sugar prices. On a positive note, there's a breath of relief as global commodity prices and imported edible oil prices show signs of moderation. While a recent weakening in crude oil prices is evident, there exists a potential for upside risks due to evolving geopolitical tensions. As a result, the inflation projections remain unchanged at 5.6 percent and 5.2 percent for Q3 and Q4 of FY 2024, respectively. Consequently, at the commencement of FY25, it is anticipated to hover around 5.2 percent, surpassing the targeted 4 percent.

Figure 2: Headline inflation forecast by RBI for three periods



Source: RBI

The sustained decline in core inflation, aligning with the easing of commodity prices and diminishing demand-side pressures, is a positive trend. However, the constant elevation in food inflation remains a matter of concern. The anticipated decrease in Kharif production and uncertainties surrounding Rabi sowing prospects introduce an upward risk to food inflation, potentially influencing inflationary expectations. Therefore, the implementation of supply-side interventions by the government is crucial at this juncture.

Looking ahead, a favorable base effect is expected to persist throughout Q4 FY24, providing some cushion against potential upward pressures on price levels. Additionally, the introduction of fresh crops into the market from January to March is anticipated to alleviate price pressures within the food basket.

Global growth concerns

Global growth is slowing at a divergent pace across economies. The most recent economic projections from the International Monetary Fund (IMF) in World Economic Outlook (WEO) indicate that global growth is anticipated to persist at 3 percent in 2023, followed by a slight decline to 2.9 percent in 2024. This signifies one of the most modest growth rates witnessed in decades. Advanced economies are projected to undergo a contraction, with growth decreasing from 2.6 percent in 2022 to 1.5 percent in 2023 and further to 1.4 percent in 2024. This decline is attributed to policy-tightening measures aimed at addressing inflation concerns. Despite the resilience observed in the global economy, especially during the initial stages of recovery, economic activity continues to lag behind pre-pandemic levels. This lag is

particularly pronounced in emerging markets and developing economies, leading to an expansion of disparities between regions. Global trade is slowing down in the face of a worldwide surge in protectionist measures. Despite substantial efforts to restore global supply chains, challenges such as high levels of debt, persistent geopolitical tensions, and adverse weather conditions contribute to heightened risks for the global outlook on both growth and inflation. Certain global risk factors weighs heavily on the growth front.

Geopolitical risks: The escalation of geopolitical risks has been heightened by the outbreak of conflict in the Middle East, posing the possibility of non-linear political and economic repercussions should the situation escalate further. These risks compound with those associated with the ongoing conflict in Ukraine and political developments such as the 2024 presidential elections in both the United States and Taiwan, especially considering the existing tensions with China. Additionally, the ongoing EU investigation into the import of Chinese electric vehicles underscores the potential for trade tensions to arise.

Stagflation risks: While headline inflation in major economies appears to be decreasing, persistent elevated core CPI inflation, excluding food and energy prices, remains a concern. Despite the rapid increase in interest rates so far, there is a risk that higher inflation expectations may become ingrained. This is particularly notable as jobless rates approach historic lows and wage growth lags behind the rising costs of living. The situation may lead to increased collective wage bargaining and strikes, mirroring trends observed in Europe. Notably, strikes in the US auto sector highlight similar risks on the other side of the Atlantic. The tension between fiscal policies aimed at providing relief for the poorest and monetary measures designed to combat inflation raises the possibility of fiscal dominance and the emergence of structural stagflation in the mid-term.

Monetary policy error: Central banks have implemented substantial cumulative tightening, yet the uncertainties surrounding the lags in monetary policy remain. There is a potential risk of tightening policy excessively and for an extended duration, potentially leading to a severe economic recession. Conversely, there is also the risk of doing too little, especially if there is another surge in inflation that solidifies high inflation and wage expectations. In either scenario, central banks face the danger of undermining their credibility. Moreover, the divergence in monetary policy approaches adopted by various central banks could introduce additional uncertainties into global financial conditions.

European energy crisis: The intensification of tensions in the Middle East raises concerns about potential disruptions in the supply of oil and gas. The resurgence of markedly higher energy prices in Europe, driven, for instance, by diminished global oil supply and increased demand during an unusually cold winter, has the potential to affect industrial production. This could result in a loss of competitiveness, decreased consumer spending amid the cost-of-living crisis, and a resurgence of inflationary pressures. The volatility in global oil prices further compounds the risks associated with inflation.

Ripple effect on domestic economy

Optimism in India's economic growth is highlighted by the First Advance Estimates (FAE), pegging the GDP growth at 7.3 percent year-on-year by the Government of India (GoI) and 7 percent by the Reserve Bank of India (RBI) for FY 2024, the presence of downside risks significantly influences the overall outlook. Despite outperforming other major economies in terms of growth, the concern arises from a slowdown in private consumption demand and the deceleration of the services sector. This is particularly troubling because, for sustained investment growth over the medium term, it is crucial to strengthen consumption growth. The escalation of global geopolitical tensions further contributes to the downside risks.

RBI's growth projections

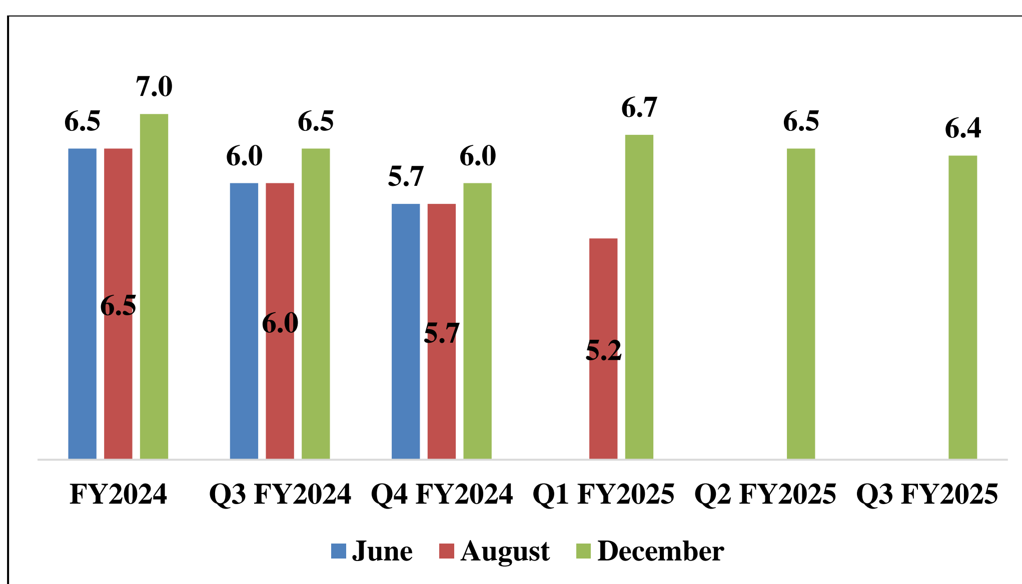
RBI has revised its GDP growth forecast for the fiscal year 2024 upward to 7 percent. In this projection, Q3 growth is anticipated to be 6.5 percent (compared to the previous forecast of 6 percent in August 2023), and Q4 is expected to reach 6 percent (up from the earlier estimate of 5.7 percent). Following this, growth is projected to rebound in Q1FY25 at 6.7 percent, followed by a slight easing in Q2 (6.5 percent) and Q3 (6.4 percent).

These upward revisions are attributed to the resilience observed in high-frequency data thus far. The RBI emphasizes the gathering momentum in the manufacturing sector during Q3, as indicated by indicators such as eight core sectors and the Purchasing Managers' Index (PMI), alongside a decline in price pressures. The service industry is also holding its ground, evident in metrics such as e-way bills, toll collections, port cargo traffic, rail freight volume, diesel consumption, GST collections, and PMI.

On the demand side, urban demand remains steady, supported by metrics such as air passenger traffic, passenger vehicle sales, and household credit. Rural demand is showing signs of recovery, reflected in the sales figures of FMCG companies, with an additional boost from festive demand. Investment demand is being driven by public sector spending, and positive trends are emerging from improvements in fixed assets and capacity utilization in private manufacturing companies.

However, the commentary suggests a slightly more optimistic outlook from the RBI, with the acknowledgment of key downside risks. These risks include potential challenges arising from Rabi sowing, influenced by the impact of El Nino, which could lead to a faltering of agricultural growth in the coming quarters and thereby impact rural demand. Additionally, the waning base effect will no longer provide support to growth figures.

Figure 3: RBI's growth projections revised upwards



Source: RBI

Looming downside risks amidst optimism

The recent upward adjustment by the RBI to the GDP projection for FY24 at 7% is viewed as leaning towards optimism. Several factors contribute to this cautious stance, including signs of weakness in the global economy, particularly in the United States, Europe, and Japan. The

uncertainty surrounding the timing of Federal Reserve rate cuts and the potential impact of El Nino on Rabi sowing in India are identified as significant risks to our growth forecast.

The repercussions of any decline in agriculture growth, influenced by factors like El Nino, could extend to negatively affect rural demand and corporate profits. Consequently, a cautious approach is warranted, and further information on Rabi sowing is awaited to better assess its potential impact on the overall GDP. The prevailing uncertainties on both global and domestic fronts underscore the need for vigilance in evaluating the trajectory of economic growth.

Taking cues on the downside risks to growth, rating agencies like ICRA, revised their growth estimates downwards by 50 bps to 6 percent. The downward revision is mainly attributed to factors such as uneven rainfall, reduced differentials with year-ago commodity prices, a potential slowdown in Government capital expenditure as the Parliamentary Elections approach, weak external demand, and the cumulative impact of monetary tightening. Goldman Sachs, the global investment bank, has estimated that the Indian economy will grow at 6.3 percent year-on-year, which is below the estimates provided by the GoI and RBI.

Conclusion

Headline inflation is likely to fluctuate between 5-5.5% in FY24. Upward pressures may arise from the volatility in food prices and international crude oil prices. Concerns are particularly raised regarding the potential increase in prices of Wheat, pulses, and spices if Rabi sowing turns out to be weaker than anticipated. Global sugar and rice prices are already flagged as areas of concern. However, it is acknowledged that effective supply chain management by the government and the prevailing subdued global commodity prices could offer some relief and act as a mitigating factor against inflationary pressures. This nuanced assessment takes into account both potential risks and mitigating factors, providing a balanced perspective on the inflationary landscape for the fiscal year.

On the growth front, the identified signs of weakness in the global economy, particularly in the US, Europe, and Japan, along with the uncertainty surrounding the timing of Federal Reserve rate cuts, are recognized as influential factors. Additionally, the potential impact of El Nino on Rabi sowing in India is identified as a significant risk, with the potential consequences of faltering agriculture growth affecting both rural demand and corporate

profits. This cautious stance is underlined by the acknowledgment that awaiting more information on Rabi sowing is crucial to gauging its impact on GDP. Taking cues from these potential risks and uncertainties into the assessment, a prudent and vigilant approach to forecasting economic growth in the coming fiscal year is warranted.