KERALA ECONOMY
2024, VOL. 5, NO.2. pp 135-146

ISSN : 2583-4436

GIFT GULATI INSTITUTE OF FINANCE AND TAXATION

Monetary policy: Upholding growth confidence amidst inflation woes and climate risks

Aswathy Rachel Varughese

Assistant professor, Gulati Institute of Finance and Taxation, Thiruvananthapuram

Abstract

The RBI's decision to maintain the status quo for the seventh consecutive time indicates a cautious approach amidst efforts to align inflation at 4% for FY2025. Climate change concerns add complexity to the economic landscape. The geopolitical tensions in the Middle East impacted the market sentiments. The cascading effects of these factors are weighing on Mint Street's decision-making, although the growth impulses are strong.

Keywords: *Geopolitical tension, rate cycles, price shock, liquidity management.*

1. Introduction

The Reserve Bank of India (RBI) has signaled a clear shift away from following the United States Federal Reserve's policy decisions in its June Monetary Policy Committee (MPC). The RBI Governor has emphasized that while they consider the impact of policy changes in Advanced Economies like the US, their rate decisions will primarily be based on domestic growth and inflation outlook. In its June 2024 meeting, MPC maintained its policy rates for the eighth consecutive time. The repo rate remained at 6.5%, the Standing Deposit Facility (SDF) at 6.25%, and the Marginal Standing Facility (MSF) and bank rate at 6.75%. The RBI also kept its "withdrawal of accommodation" stance unchanged. Interestingly, these decisions were not unanimous this time. The vote was 4-2, compared to 5-1 in the April 2024 policy meeting. Two MPC members advocated for a 25 basis points cut and a change to a neutral stance. Despite some members pushing for a rate cut, the Governor stressed that interest rate

transmissions are not yet complete, and inflation expectations still need to be brought in line with the targeted level.

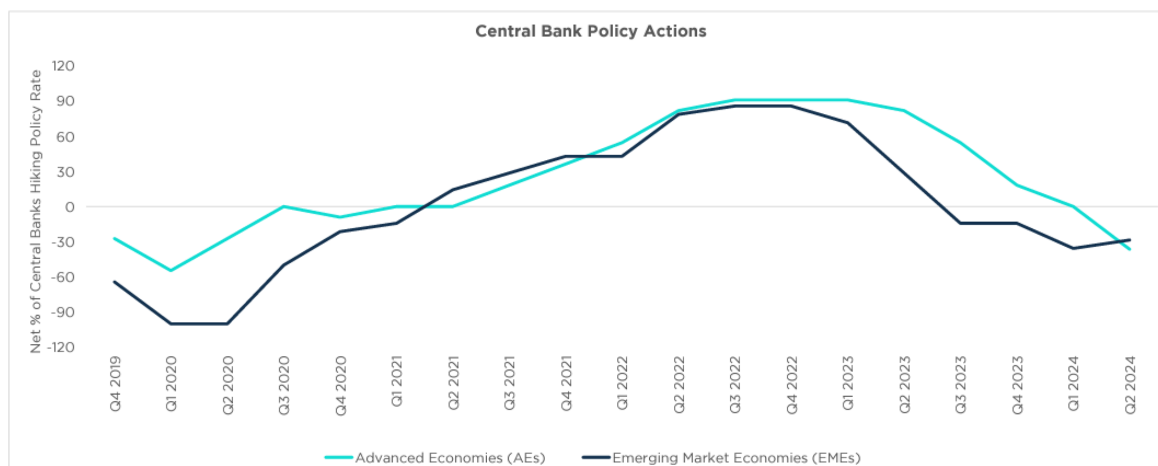
The RBI's current tone and stance suggest a potential divergence in the timing and approach to rate cuts compared to other central banks. While institutions like the European Central Bank, Bank of Canada, Swiss National Bank, and Swedish Riksbank have already begun cutting rates, the RBI appears to be charting its own course. Historical data indicates that synchronized rate actions across central banks often lead to increased market volatility. This independent approach by the RBI may help mitigate such risks.

2. Rate cycles of major central banks

Central banks worldwide often align their monetary policies with the US Federal Reserve's decisions. When the Fed increases interest rates, it typically triggers a chain reaction. Capital tends to flow out of other countries and into the US, attracted by higher returns. To counteract this, other central banks often feel compelled to raise their own interest rates. This serves two main purposes - Managing the interest rate differential to prevent excessive capital outflows and stabilizing their currency's exchange rate against the US dollar to avoid depreciation. By raising rates, these central banks also aim to keep domestic inflation in check, as a weaker currency can lead to higher import costs and inflationary pressures.

The pattern of central banks following the US Federal Reserve's lead highlights the Fed's substantial impact on global financial markets. It also illustrates the difficulties other central banks encounter in balancing economic stability with external pressures. Traditionally, the Reserve Bank of India (RBI) has been viewed as following the Fed's interest rate decisions. However, the RBI Governor has now clearly indicated a shift towards prioritizing domestic growth and inflation trends over aligning with Advanced Economies' (AEs) interest rate paths. Currently, both Emerging Market Economies (EMEs) and AEs are in an interest rate easing cycle (Figure 1). The RBI Governor's recent statement strongly suggests that the RBI's approach may diverge from the Fed's. If domestic conditions warrant it, the RBI might initiate rate cuts before the Fed does. Market analysts anticipate the RBI's first-rate cut could occur in the third quarter of the 2025 fiscal year. However, they expect this rate-cut cycle to be relatively modest in scale. This shift in approach demonstrates the RBI's increasing focus on tailoring monetary policy to India's specific economic needs, rather than automatically following global trends led by the US Fed

Figure 1: Advanced Economies (AEs) move toward rate cuts



Source: Author's computation based on Trading Economics

Figure 2: Policy actions of major central banks

Central Bank Policy Actions

	Hike	No Change	Cut
Q1 2024	Japan (20bps)	Australia, Canada, Euro Area, New Zealand, Norway, South Korea, Sweden, UK, US China, Indonesia, India, Malaysia, Philippines, , Romania, Serbia, South Africa, Thailand	Switzerland (25bps) Brazil (100bps), Chile (100bps), Colombia (75 bps), Mexico (25 bps), Peru (50bps)
Q2 2024*	Indonesia (25bps)	Australia, Japan, New Zealand, Norway, South Korea, UK, US China, India, Malaysia, Mexico, Philippines, Romania, South Africa, Thailand	Canada (25bps), Euro Area (25 bps), Sweden (25bps), Switzerland (25bps) Brazil (25bps), Chile (150bps), Colombia (50 bps), Peru (50bps), Serbia (25bps)

Source: Compiled from CareEdge Rating

Figure 2 portrays the changing interest cycle of the major central banks across the world. The European Central Bank (ECB) implemented a 25 basis point cut to its deposit facility rate in June, bringing it to 3.75%. This move was anticipated and driven by easing underlying inflation and declining inflation expectations. Despite this rate cut, the ECB projects that inflation will remain above its 2% target until well into 2025. To address this, the bank intends to maintain sufficiently restrictive policy rates for as long as necessary to achieve its inflation target.

Additionally, the ECB has outlined plans to gradually reduce its pandemic emergency purchase programme (PEPP) portfolio. It aims to decrease this by an average of €7.5 billion

per month during the second half of 2024. Market analysts anticipate further rate cuts from the ECB, expecting a 25 basis point reduction in September and another in December. These policy moves are likely to impact currency markets. The EUR/USD exchange rate is expected to face depreciation pressure as the ECB cuts rates ahead of the US Federal Reserve. Adding to the euro's challenges, political uncertainty in France is likely to exert downward pressure on the currency in the short term. This uncertainty stems from President Macron's call for a snap general election.

Bank of England (BoE) left policy rate unchanged at 5.25 percent in June even as headline inflation fell to its 2 percent target in May. However, core inflation remains elevated & BoE expects headline inflation to rise slightly in H2. BoE noted monetary policy will need to remain restrictive for sufficiently long for inflation to return to its 2 percent target sustainably in the medium term. Market expects a 25bps rate cut in August followed by another in December. UK's upcoming general elections scheduled for July 4 will be a key event, with polls indicating the opposition Labor Party is poised to secure a majority.

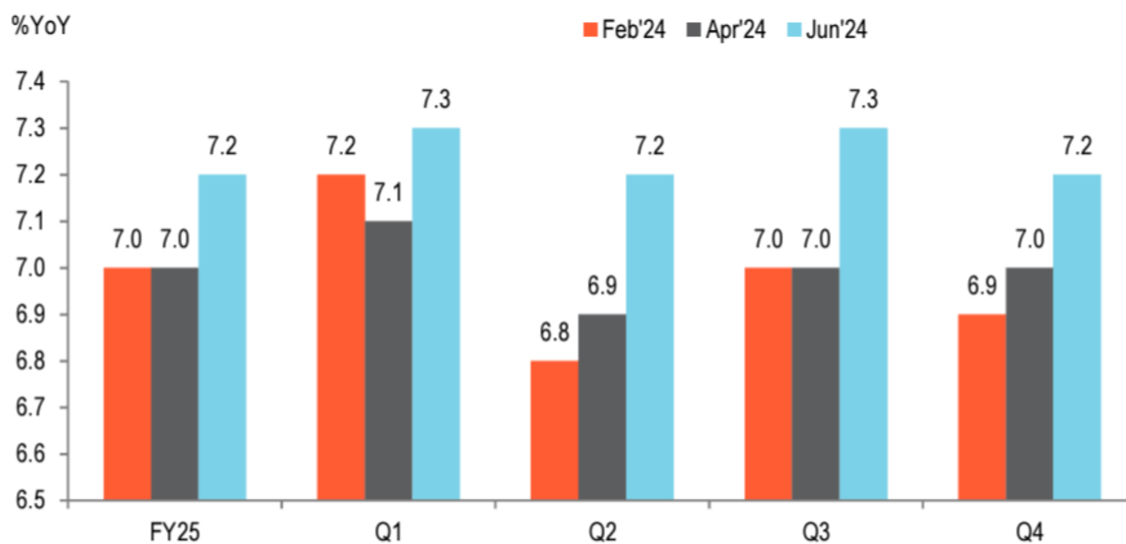
Bank of Japan (BoJ) maintained its key short term interest rate at around 0 to 0.1 percent in June, as expected. BoJ will decide on a detailed plan for reducing its Japanese government bond (JGBs) purchases at its July meeting. Market expects BoJ to gradually raise policy rate by 10bps each at its July and December meeting. Over the next year monetary policy divergence between Fed and BoJ should support JPY.

3. RBI's growth projections for the Indian economy

The RBI has revised its GDP growth projection for FY25 upward to 7.2% (Figure 3), an increase from the 7% projected in its April 2024 policy. This follows a strong 8.2% growth in FY24, which exceeded the National Statistical Office's (NSO) advanced estimate of 7.6%. The RBI has also adjusted its quarterly growth projections for FY25: In Q1: 7.3% (up from 7.1%), Q2: 7.2% (up from 6.9%), Q3: 7.3% (up from 7%) and Q4: 7.2% (up from 7%). The robust growth forecast for FY25 is based on several factors. They are sustained urban demand, as evidenced by strong passenger vehicle sales and air passenger traffic. Besides, a revival in rural demand, indicated by increased two-wheeler sales and decreased demand for the MGNREGA employment scheme. Continued improvement in investment activity, shown by increased steel consumption, cement and capital goods production, government-led infrastructure development, and investments under the Production-Linked Incentive (PLI)

scheme. Looking ahead, an above-normal monsoon is expected to boost Kharif crop output, potentially further stimulating rural demand. The services sector expansion is likely to be driven by urban consumption, while government spending is anticipated to support investment activity.

Figure 3: RBI's growth projections revised upwards



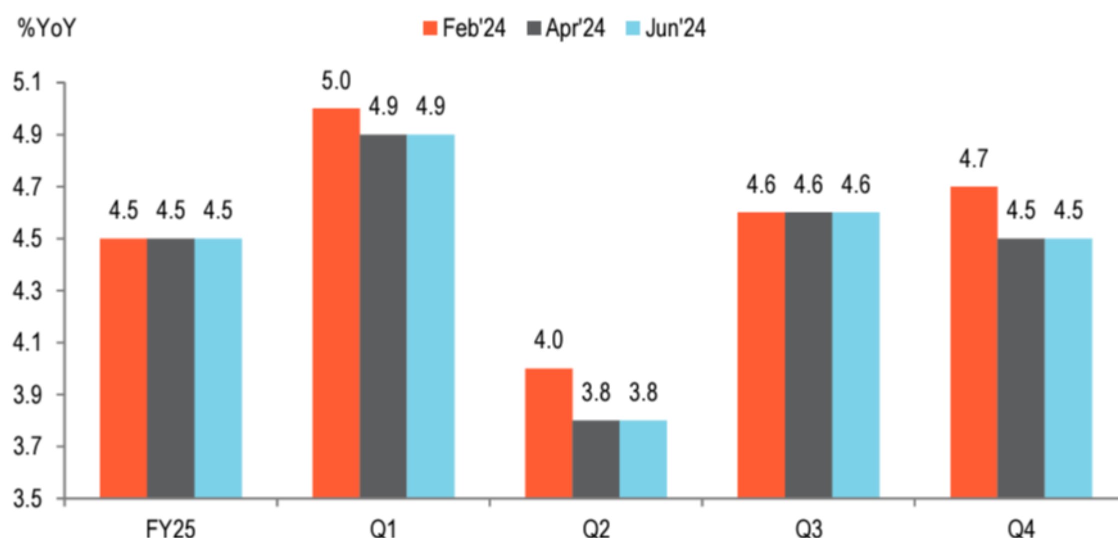
Source: RBI Monetary Policy Statement, June 2024

4. Inflation Projections

The RBI has maintained its inflation projection for FY25 at 4.5% (Figure 4). The quarterly projections also remain unchanged, with Q1 at 4.9%, Q2 at 3.8%, Q3 at 4.6%, and Q4 at 4.5%. It has also not revised these projections, as the impact of the Indian Meteorological Department's (IMD) forecast of above-normal monsoon for this season is yet to be seen. For now, the RBI has noted several upside risks to inflation. These include ongoing heat wave conditions and low reservoir levels, which are putting pressure on summer vegetable and fruit crops. Additionally, the current increase in global food and non-oil commodity prices, along with volatility in oil prices, may add to inflationary pressures. However, if abundant rainfall occurs, domestic pressures could dissipate, potentially helping to reduce inflation in cereals and pulses. The RBI also noted that the LPG price cut announced in March 2024 is already contributing to a disinflationary trend in fuel inflation. The central bank appears to be taking a cautious stance, balancing potential risks against possible mitigating factors in its inflation

outlook. This approach allows for flexibility in responding to evolving economic conditions throughout the fiscal year.

Figure 4: Inflation forecast for the financial year remained unchanged



Source: RBI Monetary Policy Statement, June 2024

5. Food Inflation continues as a key risk

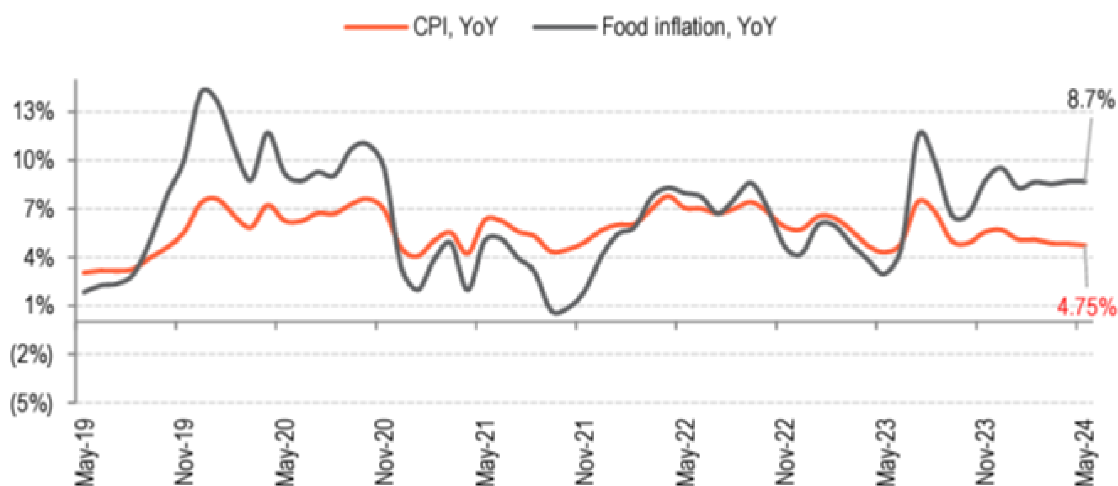
The Consumer Price Index (CPI) reached 4.75% year-over-year in May, primarily due to persistent food inflation. Food items, which account for 32% of the overall CPI basket, are showing significant upward momentum sequentially, though much of this can be attributed to seasonal factors. There's a potential for another price shock in tomatoes and onions. As of June 2024, prices of these vegetables are already rising, due to adverse weather conditions and mismatches between supply and demand. It's unlikely that food inflation will fall below 7.5-8% in the near future. Consequently, headline CPI may exceed the Reserve Bank of India's (RBI) inflation projections for Q1. Some relief is expected in Q2 due to a favorable base effect. Core inflation continues to provide comfort, although there might be some upward pressure if rural demand increases following a good Southwest monsoon. Given these factors, the RBI is likely to adopt a flexible approach, carefully balancing various risks. Several key events will be closely monitored from a monetary policy perspective, including the impact of the final Budget on growth and inflation, as well as the evolution of global policy rates. The central bank's decision-making process will need to consider multiple factors, balancing short-term inflationary pressures against longer-term economic growth

prospects and global economic trends. This complex environment underscores the need for nimble and responsive monetary policy adjustments.

In the food category, half of the 12 broad subcategories have inflation rates exceeding 6%. The most significant increases are seen in vegetables (27.3% year-over-year), pulses (17.1%), cereals (8.7%), and eggs (7.6%). Oils, fats, and fruits are also experiencing notable upward pressure. A month-to-month analysis provides a clearer picture of food inflation trends. In May 2024, food inflation rose by 0.7% compared to the previous month. However, when adjusted for seasonal factors, it actually decreased by 0.3%, indicating that some of the increase can be attributed to seasonal patterns.

Several food items are contributing to inflationary pressures, including cereals, eggs, vegetables, pulses, sugar, and spices. Looking ahead, there's significant potential for further increases in overall food inflation, though it's expected to stay below 8% in the near term. A particular concern is the possibility of another price shock in tomatoes and onions. Such an event could cause the headline CPI to exceed the Reserve Bank of India's projected trajectory. This complex food inflation scenario presents challenges for monetary policy. The RBI will need to carefully monitor these trends, particularly the interplay between seasonal factors and more persistent inflationary pressures, as it makes policy decisions. The potential for sudden price shocks in specific food items adds layer of uncertainty to the inflation outlook.

Figure 5: Untamed food inflation (y.o.y %)



Source: Ministry of Statistics and Program Implementation (MOSPI)

As of June 2024, food inflation continues to present significant upside risks (Figure 5). There have been notable monthly price increases in vegetables, particularly tomatoes and onions. The December-June tomato harvest has been affected by April and May heatwaves and early rains in some states. Onion prices are also rising due to supply-demand imbalances.

Beyond vegetables, pulses like Gram and Tur are experiencing price increases. Reports suggest that existing buffer stocks of pulses may be under strain. If these food price shocks persist, the Q1FY25 inflation figure might exceed the Reserve Bank of India's (RBI) projection of 4.9%.

Water reservoir levels are lower compared to last year (22% vs 28% for the same period, as of June 6th), which could impact agricultural output. Additionally, global food prices remain sticky. Given these factors, the trajectory of the headline Consumer Price Index (CPI) now largely depends on the distribution of the South-West monsoon. On the demand side, the picture remains unclear. Fast-Moving Consumer Goods (FMCG) companies have reported shifting to a volume-led approach by implementing price cuts in their recent financial performances. As a result, while upside risks to core inflation remain limited, some correction is expected with the anticipated pickup in rural demand. This complex interplay of supply-side pressures and demand-side uncertainties presents a challenging environment for monetary policy decisions. The RBI will need to closely monitor these developments, particularly the progress of the monsoon and its impact on food prices, as well as any shifts in consumer demand patterns, to inform its policy stance in the coming months.

6. RBI's liquidity management

In the past two months, government cash balances held with the Reserve Bank of India (RBI) have remained high, partly due to the general elections. These elevated balances, combined with the RBI's dividend transfer, have maintained a surplus in durable liquidity. However, the banking system liquidity has mostly been in deficit, with only brief periods of surplus due to month-end inflows.

The government's surplus cash balances and the RBI's dividend transfer are expected to create room for increased government spending. A rise in spending following the upcoming budget is anticipated to support overall liquidity conditions.

The RBI has committed to maintaining a flexible and adaptive approach to liquidity management. This approach aims to ensure that money market interest rates develop in an orderly manner. To achieve this, the central bank will continue to manage liquidity through both main and fine-tuning operations as needed. A key priority for the RBI is to maintain ample liquidity to support credit demand in the economy. This commitment underscores the central bank's focus on balancing monetary policy objectives with the need to support economic growth. The RBI's approach reflects its recognition of the complex interplay between government finances, banking system liquidity, and broader economic conditions. By remaining responsive to these factors, the RBI aims to create a supportive environment for stable financial markets and sustained economic growth.

7. Global front

The global economy has demonstrated resilience, with major economies performing better than anticipated. In April, the International Monetary Fund (IMF) revised its 2024 global growth projection upward by 10 basis points to 3.2%. This improved global outlook is expected to benefit India's exports. India's external economic position remains stable, characterized by adequate foreign exchange reserves and a manageable current account deficit. Foreign investment inflows are projected to remain robust, particularly due to passive inflows into the debt market following India's inclusion in major global bond indices.

Looking ahead, strong domestic growth in India, coupled with rate cuts by major central banks, is likely to attract further Foreign Institutional Investor (FII) inflows. This favorable external position, marked by high forex reserves and anticipated increases in FII inflows, provides the Reserve Bank of India (RBI) with flexibility to consider rate cuts independently of the US Federal Reserve's decisions. The European Central Bank's (ECB) recent decision to cut policy rates may signal a potential shift in the global monetary policy cycle. This global trend, combined with India's strong economic fundamentals, could influence the RBI's monetary policy decisions in the coming months. Overall, India's external economic environment appears supportive of potential monetary easing, should domestic conditions warrant it. The RBI will likely continue to balance these external factors with internal economic indicators as it formulates its monetary policy stance.

8. Justification of FOMC Policy stance and major economic indicators of the economy

The FOMC unanimously decided to keep the federal funds rate target range at 5.25-5.50% during its June 11-12 meeting, aligning with market expectations. The policy statement noted "modest further progress" towards the 2% inflation goal, a change from the previous "lack of further progress" statement. However, the Committee still views inflation as elevated and doesn't anticipate reducing the policy rate until there's greater confidence in sustainable movement towards the 2% target. In the Summary of Economic Projections (SEP), 2024 projections for real GDP growth (2.1%) and unemployment rate (4%) remained unchanged from March. However, inflation projections were revised upward. The median 2024 PCE inflation projection increased to 2.6% from 2.4%, and the 2025 projection rose to 2.3% from 2.2%. Core PCE inflation projections for 2024 and 2025 were also raised. Despite these increases, both PCE and Core PCE inflation are still expected to return to the 2% target by 2026.

The median federal funds rate projection now suggests only one 25 basis point rate cut in 2024, down from the three cuts projected in March. The number of participants projecting no rate cut in 2024 has doubled to four, while seven project one cut and eight project two. No participants foresee a rate hike in 2024. For 2025 and 2026, the projections now indicate more aggressive rate cuts, with four 25 basis point cuts expected in each year, up from three previously. The median longer-run federal funds rate projection has been revised upward to 2.8% from 2.6%.

These projections reflect a more cautious approach to rate cuts in the near term, balanced by expectations of more substantial easing in the following years. This shift suggests the Fed is carefully weighing inflation risks against economic growth considerations in its policy outlook.

Recent indicators suggest the U.S. economy is showing signs of cooling (Figure 6). After some unexpected increases, Consumer Price Index (CPI) inflation eased in April and May. The anticipated moderation in shelter prices is expected to contribute to inflation's gradual descent towards the Federal Reserve's 2% target. While the labor market remains tighter than pre-pandemic levels, some softening is evident. This is reflected in a decrease in job openings and a slight increase in the unemployment rate. Given these trends, we anticipate the Federal Reserve may implement rate cuts of 25 to 50 basis points in the second half of 2024,

potentially starting from September. This expectation is based on easing inflationary pressures and slowing economic growth. However, it's important to note that the Fed's policy decisions will remain data-dependent. If incoming economic data indicates stronger-than-expected economic conditions, the Fed may delay these anticipated rate cuts. The central bank's decisions in the coming months will likely be influenced by a wide range of economic indicators, particularly those related to inflation and labor market dynamics.

Figure 6: Major indicators of US economy

Source: Fed Reserve Database

9. Way forward

Despite overall robust growth, the economy faces challenges due to weak consumption demand. While core inflation has moderated, elevated food inflation keeps headline numbers high. The benign core inflation is a comfort for the Reserve Bank of India (RBI), as strong growth has remained largely non-inflationary. However, the Monetary Policy Committee (MPC) remains cautious, closely monitoring potential risks to the inflation outlook, particularly those arising from weather-related events and higher global commodity prices.

The RBI Governor has emphasized that domestic factors will primarily influence the bank's decisions, although they will remain vigilant of the external environment. This stance reinforces the expectation that the RBI could implement policy interest rate cuts by the third quarter of FY25, provided domestic inflation moderates. By then, the RBI will have a clearer picture of risks associated with food inflation, domestic fiscal policy outlook, and the policy direction of major central banks. India's comfortable external position, characterized by high foreign exchange reserves and expected increases in Foreign Institutional Investor (FII) inflows due to India's inclusion in bond indices, provides the RBI with flexibility for rate cuts, independent of the U.S. Federal Reserve's decisions. Bond yields are expected to soften, with 10-Year Government Securities (G-Sec) yields projected to range between 6.5% and 6.6% by the end of FY25. This outlook reflects a balanced approach by the RBI, weighing domestic economic conditions against global factors. The central bank's policy decisions in the coming months will likely be influenced by a combination of inflation trends, growth dynamics, and external economic developments.