KERALA ECONOMY
2024, VOL. 5, NO.1. pp 98-104.
ISSN : 2583-4436

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.

Introduction

In its initial fiscal year 2024-25 meeting, the Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) chose to keep the policy repo rate steady at 6.5%, supported by a 5:1 majority. Simultaneously, the MPC reaffirmed its position on 'withdrawal of accommodation,' again with a 5:1 majority. RBI committed to persistently aligning headline inflation with the 4% target, amid a robust growth outlook. The volatile food prices pose a challenge to disinflation efforts and create uncertainty in the inflation outlook. Key risks to the outlook include geopolitical tensions, fluctuations in global financial markets, and climate-related shocks. Monetary policy remains concentrated on aligning inflation with the target, aiming to facilitate sustained growth in the medium term.

Global macroeconomic scenario

The global economy has shown remarkable resilience despite repeated shocks and significant monetary tightening measures. Economic growth in the United States and several major

Emerging Market Economies (EMEs) has outperformed expectations. While manufacturing activity has been subdued, the services sector has demonstrated strength. Although headline inflation has decreased globally, core and services inflation have seen a slower decline due to ongoing tightness in labor markets. Central banks in Advanced Economies (AEs) have maintained policy rates to support the alignment of inflation with their targets.

The economic outlook and shifting expectations regarding monetary policy in AEs have caused significant volatility in global financial markets. The rapid decline in inflation, leading to anticipation of an earlier change in the US monetary policy direction, triggered a sharp drop in sovereign bond yields in November and December 2023. However, yields have since risen as central banks pushed back against overly optimistic market sentiments regarding the scale and pace of monetary policy adjustments. After a correction in Q3:2023, global equity markets rebounded strongly in November and December, particularly in AEs. The US dollar initially depreciated to a six-month low by the end of December but recovered afterward due to stronger-than-expected economic data from the United States.

From October to December 2023, crude oil prices fell due to a slowdown in global demand and increased supply from non-OPEC countries. However, prices rebounded afterward due to disruptions in major shipping routes and OPEC Plus extending production cuts until June 2024. Food prices decreased as well, driven by lower prices for cereals, meat, and vegetable oils, although sugar prices showed resilience by firming up.

Resilience in the domestic economy

The RBI's confidence in domestic growth is supported by positive trends in high-frequency data, including robust economic growth, improved labor market conditions, increasing private consumption demand, and strong public capital expenditure. PMIs for manufacturing and services indicate continued expansion in the organized sector. Industrial production grew by 5.9% from April to January FY24, compared to 5.6% in the same period last year, with infrastructure and construction goods contributing significantly to the overall Index of Industrial Production (IIP) growth of 10% during April to January FY24, up from 8.5% last year.

E-way bill collections saw a significant increase of 18.9% YoY in February, up from 13.2% YoY in December. February 2024 witnessed a remarkable 24.3% YoY surge in automobile sales, notably driven by increased demand for two-wheelers and passenger cars. According to CMIE's data, the all-India unemployment rate averaged 7.4% in Jan-Feb 2024, showing an improvement from 9% in Q3 FY24. This improvement was evident in both urban and rural areas, with rates averaging 8.7% and 6.8%, respectively, lower than the Q3 FY2024 averages of 9.3% and 8.8%. The rural labor market's positive trend was highlighted by four consecutive months of decline in MNREGA job demand (persons).

Other high-frequency economic growth indicators, such as retail credit growth and GST collections, continue to show robust performance. The RBI has maintained its growth projection of 7% for FY25.

Globally, the economy has displayed resilience, with major economies maintaining better-than-expected growth. This positive global economic outlook will bolster India's export prospects. Over the initial three quarters of FY24, India saw a significant reduction in its current account deficit (CAD), mainly due to a decline in merchandise trade deficit, coupled with strong growth in services exports and substantial remittances. With robust trade figures, we anticipate the CAD to be at 0.7% of GDP for FY24. Foreign investment inflows remain robust, particularly driven by strong Foreign Portfolio Investment (FPI) inflows and India's inclusion in major global bond indices. The strong performance of the domestic economy is expected to sustain FPI flows in the future.

India's external sector outlook remains optimistic, supported by robust macro fundamentals. However, the RBI stressed the need to closely monitor external developments, especially given increasing geopolitical tensions and rising global public debt, which could impact emerging economies like India. RBI reaffirmed that India's forex reserves, amounting USD 645 billion, are sufficient to manage any external challenges (Table-1).

RBI's Growth Outlook (%)					
	FY25	Q1 FY25	Q2 FY25	Q3 FY25	Q4 FY25
Apr-24	7.0	7.1	6.9	7.0	7.0
Earlier (Feb- 24)	7.0	7.2	6.8	7.0	6.9

Source: RBI, MPC document

Inflation woes from the upside risk

The RBI found reassurance in the mild core inflation but expressed caution regarding the overall inflationary picture. Headline inflation decreased notably from 5.7% in December to

5.1% in both January and February. This decline in inflationary pressures has been widespread, with core inflation consistently decreasing and staying below the 4% mark for three consecutive months.

While food price volatility remains a significant concern for the RBI's efforts to align headline inflation with the 4% target, there are positive developments in the outlook for food inflation. This is attributed to increased acreage of rabi sowing and expectations of a normal monsoon. However, the Central Bank remains cautious about the impact of high food inflation on household inflation expectations.

The government's supply-side measures to control food inflation and recent cuts in LPG and fuel prices are favorable for the inflation outlook. Nonetheless, ongoing geopolitical tensions and associated supply-side risks in commodity prices need careful monitoring. Climate-related risks, both domestically and globally, have also emerged as significant factors affecting food inflation in recent years. The RBI has maintained its inflation projections for FY25 at 4.5%, acknowledging the complexities and risks in the inflationary environment.

Figure – 1 Inflation Trends

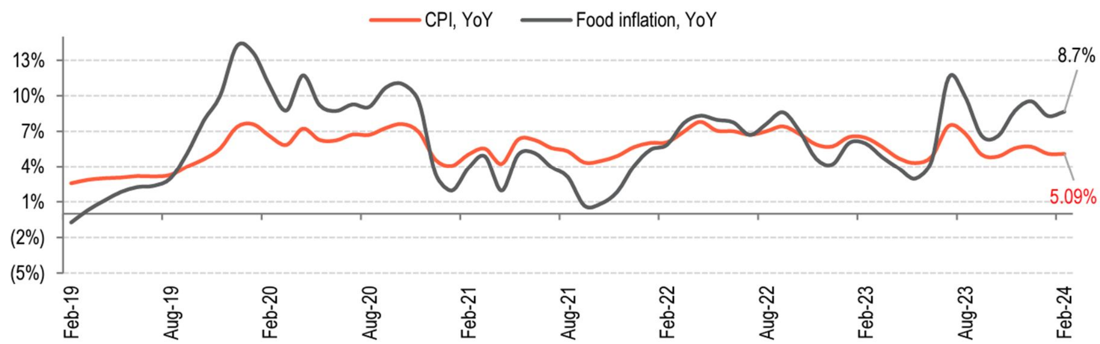
Source: RBI

Food inflation increased to 8.7% in February 2024, up from 8.3% in March 2024. Within the food category, there was notable pressure on meat and fish inflation, rising from 1.2% in January 2024 to 5.2% in February 2024, along with egg inflation increasing to 10.7% from 5.6%. This upward trend is mainly due to an unfavorable base effect. However, there is some sequential momentum observed in meat and fish inflation.

Besides, vegetable inflation also saw an uptick, rising to 30.2% in February 2024 from 27.1% in January 2024. So far, 6 out of 12 broad categories of food inflation have remained above

6%. Among major items, only cereals and spices are experiencing a moderation in inflation, both sequentially and year-on-year. Interestingly, international prices for cereals also decreased in February 2024, according to World Bank data.

Figure – 2 Food inflation trends



Source: MOSPI

On a sequential basis, food inflation increased by 0.1% in February 2024, rebounding from a decline of -0.7% seen in January 2024. Notably, vegetable prices have risen considerably, with the pace of deflation slowing down to -0.1% in February 2024 from -4.2% in January 2024. Deflation in fruit categories has also moderated to 0.3% from -2.1% in January 2024. Furthermore, meat and fish, oils and fats, and pulses have also shown a sequential increase.

Looking ahead, the trajectory of food inflation remains uncertain, with weather variability posing a key risk. The reversal of seasonality in vegetable prices is expected to begin from the first half of the year onwards. Consequently, food inflation may impede the Consumer Price Index (CPI) from declining towards the targeted 4%.

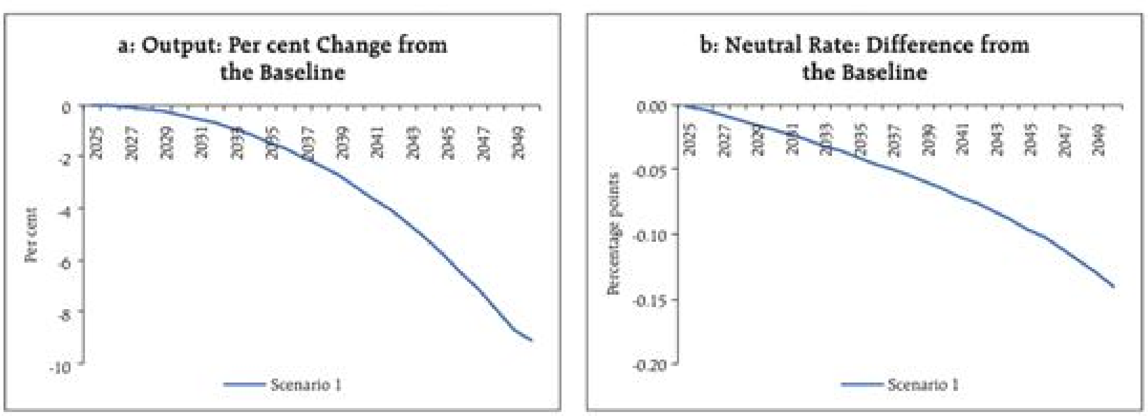
Core inflation softened further to 3.3% in Feb'24 from 3.6% in Jan'24, on YoY basis. All components of core inflation showed moderation. Amongst them, health (4.5% in Feb'24 from 4.9% in Jan'24), household goods and services (2.8% from 3.1%, due to favourable base) and clothing and footwear witnessed considerable moderation. The sequential momentum of core inflation has also lost steam, softening to 0.2% in Feb'24 from 0.3% in Jan'24, on MoM basis. Amongst major items, inflation has softened considerably for health, personal care and effects (due to moderation in gold prices), education and recreation and amusement. However, the trajectory of housing needs some monitoring.

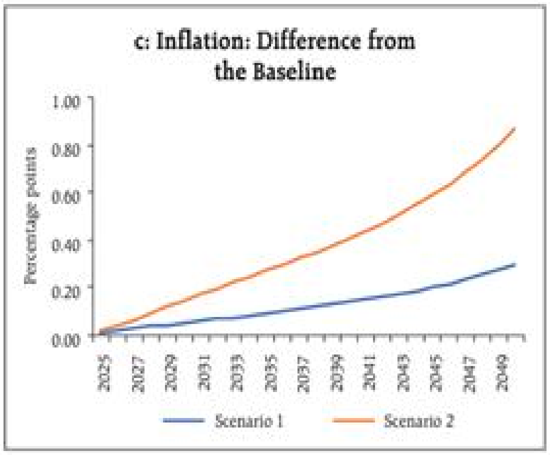
The high-frequency price data for March 2024 indicates some upward movement. Specifically, 8 out of 20 essential commodities are showing a sequential increase in prices. Notably, there is a correction in the trajectory of onion and potato prices already underway. Looking ahead, it is likely that inflation will likely remain above 5% until June 2024. FMCG companies have announced price increases, which could impact inflation in the short term. However, a favorable base effect will kick in from the second quarter onwards, potentially pushing inflation back towards the targeted 4% level. While remaining comfortable with core inflation, the trajectory of housing prices is crucial, especially with the anticipated increase in House Rent Allowance (HRA).

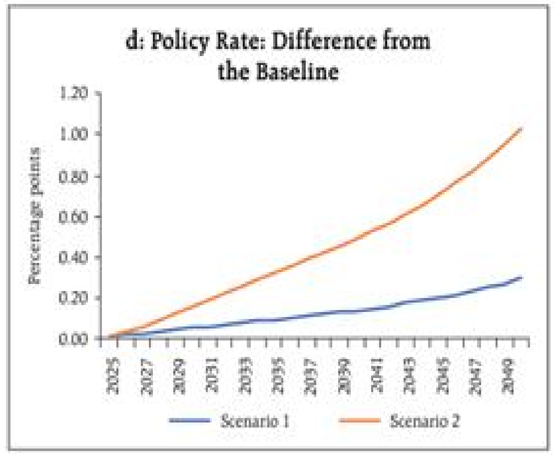
Accounting for Climate Risk

Global average temperatures are indeed rising, leading to more frequent extreme weather events (EWE), which are showcasing the economic and social consequences of global warming. Climate change can impact monetary policy through various channels. Firstly, it directly affects inflation by disrupting agricultural production and global supply chains during adverse weather events. Secondly, climate change may alter the natural rate of interest as rising temperatures and EWE can lower productivity and potential output. Lastly, the aftermath of climate change might hinder the transmission of monetary policy measures to financing conditions for households and businesses. Due to these factors, central banks are increasingly integrating climate risks into their modeling frameworks.

Figure – 3 Impact of physical risks of climate change







Source: RBI Monetary Policy Report (2024)

Way forward

MPC observed that domestic economic activity remains robust, supported by strong investment demand and positive business and consumer sentiments. Although headline inflation has decreased from its peak in December, persistent food price pressures have hindered the ongoing disinflation process, creating challenges for achieving the inflation target. Unpredictable supply-side shocks from adverse climate events, as well as geopolitical tensions impacting trade and commodity markets, have added uncertainties to the economic outlook.

Given the need for sustained disinflation until inflation reaches the 4% target consistently, the MPC opted to maintain the policy repo rate at 6.50% during this meeting. Monetary policy will continue to prioritize disinflation to anchor inflation expectations and ensure effective transmission. The MPC is committed to aligning inflation with the target to achieve durable price stability, which will lay the groundwork for a period of strong economic growth. Besides, the MPC reiterated on gradually withdrawing accommodation to facilitate inflation alignment while supporting growth.