Ketchum Sampark

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EXPERT VIEW

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CHEAP MONETARY POLICY AT A TIME OF WIDENING FISCAL GAP

The double whammy from the just announced inflation and industrial growth data was a tad unexpected. Factory output in December contracted by 0.3%, the Central Statistics Office data shows. Manufacturing which is almost 80% of the industrial index contracted by 1.2%, capital goods by 18%, consumer durables by 6.7% and consumer non-durables by 3.7%.

On the other hand, inflation for the month of January has shot up to 7.6%—food inflation stayed close to 14% for a second month in a row; meat, fish and eggs inflation is at 10.5% and pulses at 16%.

The message from these numbers needs to be digested. This is no passing one-bad-onion-crop driven inflation. This is a much broader food inflation encompassing all protein foods. The food and consumer price index (CPI) inflation of 2011-12, incidentally, had similar traits.

To come back to the January CPI, even non-food non-fuel inflation (or services inflation) has inched up to 4.2%, that is above the 4% mark mandated by the monetary policy framework. Services can't be imported and hence they represent an economy's enduring inflation.

High inflation at a time of contracting growth cannot last and so one may argue the Reserve Bank of India need not worry much. But the coexistence of the two even for a quarter or two, can seriously reduce options to spur growth and what's worse, endanger financial stability.

RBI made light of one month's CPI running over 7%, but now with the January reading, its Q4 forecast has to be revised higher. Past experience shows that protein foods inflation, accompanied by a rising global food inflation reflected in the FAO index, tends to last. The implication of this high inflation for the next couple of quarters is that the RBI shouldn't make efforts to drive rates down too much, and if it does, those efforts may not succeed.

Printing and spending money can be risky owing to high fiscal deficit, inflation

A depositor faced with negative real interest rates may react by saving less in the banks. It may also be morally wrong for the government to slash small savings rates—which are around 7%—at a time when inflation is running higher at 7.5% and food inflation at 13%. The plight of pensioners dependent solely on interest income, in a country devoid of a social security net, needs to be kept in mind.

Conversely, the green shoots of growth we saw in the higher purchasing managers' index (PMI) numbers for January and in the November and December core sector numbers have been belied by the December industrial numbers. February, if not January data itself, may show the strain of lower tourism and China-related supply chain shortages. And this external slowdown pressure may be exacerbated by the steep fall in transfers to states this quarter.

The latest budget has slashed transfers to states this year from ₹8.1 trillion to ₹6.56 trillion. Icra estimates that the central tax transfer to states may be only ₹1.7 trillion, in the March quarter this year versus ₹2.7 trillion in the same quarter last year. This can force states to keep salaries unpaid and bills uncleared. A second round of cash-flow choking the economy may follow, even before the current one ends, increasing loan defaults in its wake.

So far, the RBI has liberally sloshed liquidity through open market operations, buying government securities under various names and schemes. But printing (money) and spending can be a dangerous game in a context of high fiscal deficit and high inflation.

Our comfort has been that crude is barely $55 and our current account deficit is at historic lows of around 1%. But that we are not vulnerable on the exchange rate front today, doesn't mean the stability is sustainable.

Stock market valuations are already in bubble terrain. So far investors and policy makers have enjoyed the ride on the consolation that all markets are awash with liquidity and stretched valuations.

But the difference is, most other countries, especially developed ones, are weighed down by low inflation that refuses to touch even 2%. We are not in that comfort zone by a distance. Should something so astray in global markets due to geopolitics or viruses, we can face a sharp attack on our exchange rate.

The RBI's mandate is more than inflation; it is basically to maintain financial stability. Given our vulnerabilities on several fronts, the RBI must be more than watchful before it goes on any print and spend spree. The beginner's luck of governor Shaktikanta Das may be running out.