

India's central bank has to deal with challenges on multiple fronts.

One is domestic inflation; another is falling value of the Indian rupee relative to US dollar; volatility in the global price of crude oil; outflow of capital, partly reflecting political uncertainties and the resultant decline in consumer confidence.

The Monetary Policy Committee at its two-day meeting scheduled on July 31 and August 1 has to revise its decision of a neutral monetary stance of wait and see to a more hawkish one, as things are heating up.

Let us take up inflation first.

The Reserve Bank of India (RBI) targets inflation, which is the rate of change in consumer price index. That is the upper limit of tolerance level of 6%; and lower limit is 2%.

**Consumer Price Index (CPI)**

The most important category in CPI is food and beverages (45.86% of total weight), of which cereals and products (9.67%), milk and products (6.61%), vegetables (6.04%),

# Challenges before RBI

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month (MoM) changes and year on year changes (YoY) in percent as well. Similarly the trends in wholesale price index (WPI) movements, MoM changes in percent and YoY changes in percent. The year on year changes are also referred to annual inflation.

What would be the chief worry of monetary authorities is the steep rise in the annual inflation rate. Table 1 shows a steep rise from 2.74% in March to 3.64% in April and then to 4.43% in May and finally to 5.77%. This is a 54-month high.

The WPI, which excludes services but includes goods and products is no longer the target since 2013. However it is important, since it also used the GDP deflator as well for calculating the Index of Industrial Production.

Rising crude oil prices were responsible for accounting 214 basis-points month-on-month jump in June for the primary articles group; and for double-digit price increase in the fuel and power group. Prices of onion and potatoes have shot up. In particular, the annual rise in potato prices was steep for five

**Table 1 : Crude oil price , WPI Index , CPI Index, Month on Month Changes and Annual Inflation (percent)**

Months	Crude oil price: \$/barrel	WPI	WPI MoM Change	WPI Inflation YoY Change	CPI	CPI MoM Change	Inflation YoY Change
2017 Dec	60.88	115.7	-0.52	3.58	137.2	-0.29	5.21
2018							
January	66.56	115.8	0.09	3.02	136.9	-0.22	5.07
Feb	63.72	115.8	0.00	2.74	136.4	-0.37	4.44
March	63.8	116.0	0.17	2.74	136.5	0.07	4.28
April	69.4	116.8	0.69	3.62	137.1	0.44	4.58
May	79.41	117.9	0.94	4.43	137.8	0.51	4.87
June	74.94	119.2	1.10	5.77	138.6	0.57	5.0

Source: RBI Monthly Bulletin, Trading Economics and Author's calculations

prepared meals, snacks, sweets, etc. (5.55%), meat and fish (3.61%) and oils and fats (3.56%). The next category is miscellaneous, which accounts for 28.32%, comprising transport and communication (8.59 %), health (5.89%), and education (4.46%). Next comes housing (10.07% followed by fuel and light for 6.84%; clothing and footwear (6.53%; and pan, tobacco and intoxicants (2.38%).

While CPI movements are used for calculating headline inflation, some items of extreme price volatility such as food and fuel and energy products are excluded to determine core inflation.

Table 1 presents the trends in CPI movements, month on

straight months, contributing to inflation in vegetable prices: from 2.51% in May to 8.12% in June.

Increase in the price of manufactured products has also been of concern. It is the third key group-level constituent of the WPI with the largest weight of 64.2%. It also recorded annual inflation in June at 5%. So that is about the past.

**How about the immediate future?**

We have the government's decision to raise the minimum support price (MSP) for the kharif crops. In addition, one cannot ignore some unpredictable element of monsoon with either poor or excess rain and floods, impacting food and agricultural output as well.



The fiscal impact of MSP and of course likely handouts and freebies, with elections soon in four states : Rajasthan, MP, Chattisgarh, Mizoram and General Elections in May 2019 would also be another area of concern.

**Uncertain global crude oil prices**

Thanks to President Trump's persuasion, Saudi Arabia has been pumping out more crude oil. The oil price has fallen. Brent crude oil price decreased last week by 9% over the week due to expectations of greater oil supply. Lower oil price would result in lower import cost of oil for India. It would also improve current account deficit in the balance of payments, as India imports three fourths of its oil requirements. We cannot pin hopes on Saudi Arabia's decision alone to raise oil output. Uncertain world conditions may change the situation.

Although on July 18, the rupee gained by 0.42% and rose to ₹ 68.26 per US dollar, from the record low of ₹ 69.09 on June 28, it is still not on safe territory. The US Federal Reserve decision to raise its policy rate is very much on the cards. That would only strengthen the dollar further.

That means the rupee will slide down. The attraction of foreign portfolio investment in Indian debt securities and equity is on the wane. It is reported foreigners have sold Indian shares worth ₹ 27,000 crore in April-June period. Capital outflows have made the Indian rupee as the worst performer in Asia, as Table 2 indicates. The RBI has been intervening in the market selling US dollars for rupees and artificially propping up the rupee.

**USA wants a weak dollar**

President Trump does not like a strong dollar. He has given hints to US Fed Chairman Jerome Powell not to raise the policy interest rate. But, the US Fed would go its own way. In fact, as Peter Coy wrote on July 19 in Bloomberg Businessweek.

"To maintain its credibility with the financial markets in the face of an attack from the White House, the Federal Reserve

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**Table 2: Spot Rate Gains and Losses of Major Asian Currencies ..... (As of July 2018)**

Currencies	% Gain & Loss
Japanese Yen	+28.00
Hong Kong Dollar	-0.44
Malaysian Ringgit	-0.47
Singapore Dollar	-2.49
Thai Baht	-2.67
Taiwanese Dollar	-3.03
Chinese Renminbi	-4.23
Offshore Chinese Renminbi	-4.52
South Korea Won	-5.80
Indonesia Rupiah	-6.72
Philippines Peso	-6.74
India Rupee	-7.41

Source: Bloomberg

could raise the federal funds rate more than it otherwise would—showing it won't be pushed around."

So, the question is what will RBI do now?

The RBI will also show its independence.

It cannot influence government's fiscal policy and control fiscal laxity. It can do only what it should do. It will raise its policy rate by another 25 to 50 basis points.

That is the only option as it is mandated to maintain price stability.



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[The views expressed by the author in this article is his own.]