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What will be the RBI's new policy rate?

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Business leaders, investors and consumers from all sections of the community are anxiously awaiting the decision of the Monetary Policy Committee of Reserve Bank of India (RBI) which meets for three days: June 4 to June 6.

The decision on the new interest rate would also indicate the fresh monetary policy stance holding good for the next six to twelve months. It looks there will be a shift from neutral to hawkish, which would influence the economic future of the country. The current situation is filled with fears of inflationary potential, which is fuelled by rise in international crude oil price pushing up the costs of operation in all economic activities.

Depreciation of the rupee

The falling value of the Indian rupee has compounded the problem. The resultant escalation of the landed prices of commodities or capital and intermediate goods imported for every manufacturing activity, including for production of exports, would also contribute to emergence of new concerns. Table 1 shows the rupee in a very unfavourable light, its worst performance in comparison to all other leading currencies of Asia. The global economic environment including the rise in crude oil price, the so-called trade war, the first shots fired by the largest economy against the second largest economy, the cancellation of the Iran nuclear treaty and a host of other problems, such as the likely hike in the US benchmark interest rate are all common to all countries. Yet the impact of the economy on the Indian rupee seems to be much more severe.

The reason is the pull out of funds from India by foreigners in recent weeks. Since 1992, foreign portfolio investors (FPI) and foreign institutional investors (FII) were allowed to invest in India's debt and equity markets. These money flows are highly sensitive to expectations of returns. They

are dubbed as hot moneys, as distinguished from foreign direct investment in fixed assets in terms of plant and machinery for manufacturing for domestic or for export markets, which cannot be pulled out that easily.

Confidence in the economy brings in capital flows and goes out as confidence evaporates! India has attracted funds and now if these go out, the reasons are obvious for the easy-come-go as well. The total flows comprise CAD, FDI and FPI. The latest assessment is while the total flows in fiscal year 2014-15 and fiscal year 2016-17 were in the positive territory; they were negative in the fiscal Y 2018 just ended.

In 2017, FPI net inflows amounted to \$31 billion (equities: \$8 billion and debt: \$23 billion). However, there has been reversal of flows: Overseas investors took the funds out by selling equity stocks and bonds during January- May 2018. The outflows totaled \$3 billion. No wonder, the ever volatile hot money outflows lived up to their notoriety and damaged the value of the rupee.

Table 1: Spot Rate Gains and Losses of Major Asian Currencies (as of May 15)	
Currency	Percentage Gain and Loss
Offshore Renminbi	2.48
Japanese Yen	2.46
Malaysian Ringgit	2.28
Chinese Renminbi	2.27
Thai	
Baht	2.04
Taiwan Dollar	-0.17
Singapore Dollar	-0.2
South Korean Won	-0.28
Hong Kong Dollar	-0.46
Indonesian Rupiah	-3.34
Philippines Peso	-4.54
Indian Rupee	-6.22

Source: Bloomberg

Exports are remaining stagnant at a monthly average of \$25 billion. With total imports of which nearly 30% of which are petroleum crude, have been up at higher prices than before, the trade (in goods) balance is negative. It is estimated in the just ended fiscal year 2017-18, imports were around \$38 billion a month; and with \$25 billion as exports averaging each month, trade deficit (TD) would be around \$13 billion a month. Thus the forecasts are total exports were \$303 billion

and imports \$460 billion. The trade deficit is estimated at \$157 billion. This is higher than \$109 billion of 2016-17. This is also the highest in the recent five-year period. The current account (which includes goods and services as well as factor payments and financial transfers) balance is expected to deteriorate further in the next few The annual current account deficit (CAD), is to be around \$49 billion, a close 2% of GDP.

Table 2 presents data for last 18 fiscal years. When the price of oil exceeded US\$ 111 in 2012-13, CAD rose to its highest at 4.8% of GDP.

Fiscal Year	Ave Crude Oil Price \$/Barrel	Goods Trade Bal % of GDP	Current Account Balance % of GDP
2000-01	28.4	-2.70762	-0.57934
2001-02	24.51	-2.4221	0.71152
2002-03	25.01	-2.10769	1.25101
2003-04	28.83	-2.28839	2.34928
2004-05	38.1	-4.67053	-0.3423
2005-06	54.38	-6.22188	-1.18698
2006-07	65.14	-6.50942	-1.00778
2007-08	72.52	-7.38419	-1.27053
2008-09	96.99	-9.76378	-2.28036
2009-10	61.59	-8.65714	-2.79636
2010-11	79.47	-7.44324	-2.80426
2011-12	111.27	-10.40579	-4.2
2012-13	111.63	-10.70553	-4.80645
2013-14	108.56	-7.94999	-1.7373
2014-15	99.53	-7.12097	-1.31616
2015-16	52.35	-6.22426	-1.0569
2016-17	43.55	-4.967	-0.67272
2017-18 (Est.)	54.25	-6.2	-1.9
2018 May	80.00	NA	NA

Note: Trade & current account balances for 2017-18 are estimates

Rising oil price and inflation

The connection between oil price and domestic inflation is obvious. With production cost of every economic activity is influenced by transport cost, either in regard to movement of raw materials, or of food and vegetables and finished products to retail shops, consumer price index

has to reflect the rise in transport cost. Table 3 illustrates the connection between oil price and inflation.

Table 3: India: Crude oil price, CPI index and Inflation			
	Crude oil Price \$/barrel	CPI index	Inflation %
2017 May	49.54	131.4	2.18
June	46.7	132	1.54
July	48.68	134.2	2.36
August	49.54	115.4	3.36
Sept	54.1	135.2	3.28
Oct	55.24	146.1	3.58
Nov	60.5	137.6	4.38
Dec	60.88	137.2	5.21
2018 January	66.56	136.9	5.07
Feb	63.72	136.4	4.44
Mar	63.8	136.5	4.28
April	69.4	137.1	4.58

The rise in oil price in the last three months (Feb to April of 2018) has resulted in inflation going up to 4.58% in April 2018. In May 2018, oil price has already touched \$80 and soon we will have another upward revision in consumer price index for May. It would be a close 6%.

What will be the RBI decision?

With all the alarming signs on the horizon facing the economy, the natural tendency is to look back and check the recent history. The 2012-13 trends in oil price and inflation, currency movements have close resemblance to the latest recent economic scene. At the same time there are dissimilarities as well.

First, some similarities, oil price shot up in 2012-13 to \$111.63/barrel; and inflation was high at 8.4%. In 2012-13, imports averaged at \$41 billion/month, quite close to \$39 billion/month as in 2017-18; and exports at \$25/month, both in 2012-13 and 2017-18. Yet another similarity was in regard to rupee-dollar exchange rates. There was sharp fall in rupee in June 2013. The rupee fell from 56.76 to 67.88. The former Deputy Governor, RBI, Rakesh Mohan and Prof Partha Ray in their 2017 IMF Working Paper put the blame rightly on the outflow, thus: “the episode of sharp depreciation was primarily triggered by the outflow of FII investment (both debt and equity) following tapering hints the US Federal Reserve”.

We have a similar situation here. Foreigners buy Indian bonds because of favorable interest rate differential compared with other countries after evaluating currency risks. A narrowing gap differential, with US bond rates going up pulls away FII from Indian bonds.

So what would RBI decide next month in the meeting of the Monetary Policy Committee?

It can do what RBI did in July 2013.

The circumstances are similar except for a few things. The foreign reserves today are far higher at \$ 396 billion, as compared to \$ 270 billion then; and the reserves are sufficient to cover 10 months of imports as compared to 7 months of imports in 2013.

The then new RBI Governor, Raghuram Rajan in his maiden monetary policy decision raised the policy rate by 25 basis points. The rise in interest rate was primarily an anti-inflationary measure. But it certainly helped preventing further outflows of capital.

Improving the economic climate?

That is left to the government in power. The central bank cannot do it alone.

With rising non-performing assets of banks, and the second largest public sector bank, the Punjab National Bank being downgraded by the rating agency Moody's, from the local and foreign currency deposit rating to Ba1/NP from Baa3/P-3 along with downgrading the bank's baseline credit assessment and foreign currency issuer rating, things are not rosy anyway.

The crony capitalism nurtured by the politicians-businessmen nexus ever since the nationalization of banks and unwillingness to initiate major reforms including privatisation of banks would continue to weaken the pro-growth climate, which would only aggravate sovereign and currency risks.