Growth or Stability?

Dr. T. K. Jayaraman

The world is witnessing a strange contest between central banks: which will be the first one to raise its policy interest rate further to a next high; and by how many basis points more?

Having missed the bus, the monetary authorities now feel so desperate that they have to stop the rising price level. Global inflation is going out of hand. It is not just inflation due to high money supply, which was resorted to meet the impact of black swan event (BSE) of Covid-19 during 2020-21. But another 2022 BSE, the ongoing Russia-Ukraine War since February 2022 and the resultant fall in supply of critical inputs, petroleum crude and natural gas and wheat and food grains, besides the supply chain disruptions, are all leading to decline in world trade. The third BSE lurking around the corner is recession: not just stagnation in output, but continuously falling aggregate demand and decline in output with loss of incentives to produce, leading to loss of jobs.

The International Monetary Fund (IMF) released its routine, bi-annual World Economic Outlook (WEO), just a day prior to their October 2022 joint biannual meeting of IMF and the World Bank, which was attended by finance ministers and central bank governors. The WEO October 2022, carrying the subtitle: "Countering the Cost-of-living Living Crisis" presents the situation of slow or no growth, with high inflation. It forecasts that global growth is expected to slow down to 3.2% in 2022 from 6.0% in 2021 and to decrease further to 2.7% in 2023.

Weakest growth profile

The WEO 2022 presents the "weakest growth profile since 2001 except for the global financial crisis (2007-08) and the acute phase of the COVID-19 pandemic (2019-21)". Global inflation is forecast to rise from 4.7% in 2021 to 8.8% in 2022 but to decline to 6.5% in 2023 and to 4.1% by 2024. The inflation forecasts for the advanced economies for 2022 and 2023 are the US: 8.1%, and 3.5%, Eurozone: 8.3%, 5.7%; and emerging market economies are India: 6.9% and 5.1%; and China: 2.2% and 2.2%.

Giving priority to growth in the midst of inflation, the British government headed by Prime Minister Liz Truss, who resigned in early October, 2022 had decided in favour of tax cuts. The policy reversal and the change in the government on October 26 2022, with Prime Minister Rishi Sunak were welcomed by the markets. The rise in bond yields came down; and the pound appreciated. The new government headed by Prime Minister Sunak assures fiscal stability would receive top priority. It is likely that stability would be sought to be achieved by higher taxes on capital gains and inheritance taxes, rather than reduction in public expenditure. Monetary tightening would now be the focus of the Bank of England.

End of easy money policy era

Current global situation is a product of easy money policy pursued by central banks for long years with low interest rates for meeting the Great Recession (2008-2009) following the financial crisis of 2007 and subsequent delays including the taper-tantrum years (2013-15) in getting back to normalisation of monetary policy. The Russia-Ukraine conflict since early 2022 and the supply-chain bottlenecks and rising oil and energy prices, have led to inflationary pressures which needed fire-fighting solutions from central banks, in the form of monetary tightening.

The US Federal Reserve, delayed its response to rising inflation ever since March 2021, when the targeted rate of inflation of 2% was breached. The central bank of US, the Federal Reserve (the Fed) kept the policy rate low beyond March 2021, as close to 0.25% on the belief that signs of rising domestic price level were transient due to transitory factors. When inflation signs became "real", the Fed woke up. That was late. Only after 12 months, in March 2022, nearly after 12 months, the Fed raised it by 0.25%. The policy rate

TABLE 1 (In %)

Major and Emerging Economies: Growth and Inflation Rate Forecast for 2022 and 2023

Regions/ Countries	Real GDP Growth Rates			Inflation Rates		
	Actual	Projections		Actual	Projections	
	2021	2022	2023	2021	2022	2023
World	6.0	3.2	2.7	4.7	8.8	6.5
USA	5.7	1.6	1.0	4.7	8.1	3.5
Eurozone	5.2	3.1	0.5	2.6	8.3	5.7
Japan	1.7	1.7	1.6	-0.2	2.0	1.4
UK	7.4	3.6	0.3	2.6	9.1	9.0
Canada	4.5	3.3	1.5	6.9	4.2	2.0
China	8.1	3.2	4.4	0.9	2.2	2.0
India	8.7	6.8	6.1	5.5	6.9	5.1
Brazil	4.6	2.8	1.0	8.3	9.4	4.7
Russia	4.7	-3.4	-2.3	0.7	13.8	5.0
South Africa	4.9	2.1	1.1	4.6	6.7	5.1

Source: IMF World Economic Oultook, October 2022

TABLE 2 (In %)

Inflation and central bank policy rates in US and India (2021 Jan to 2022 September)

Year, Month	UNITED STATES		INDIA	
	Inflation	Policy Rate	Inflation	Policy Rate
2021 January	1.40	0.25	3.5	4
February	1.7	0.25	4.5	4
March	2.6	0.25	5.6	4
April	4.2	0.25	5.1	4
May	5	0.25	5.2	4
June	5.4	0.25	5.6	4
July	5.4	0.25	5.3	4
August	5.3	0.25	4.8	4
September	5.4	0.25	4.40	4
October	6.2	0.25	4.5	4
November	6.8	0.25	4.9	4
December	7.0	0.25	5.7	4
2022 January	7.5	0.25	6	4
February	7.9	0.25	6.1	4
March	8.5	0.25	7	4
April	8.3	0.25	7.8	4
May	8.6	1	7	4.4
June	9.1	1.75	7	4.9
July	8.5	2.5	6.7	4.9
August	8.3	2.5	7	5.4
September	8.2	3	7.4	5.9
October	Expected Nov 10	Expected Nov	Expected Nov 12	Expected Dec 7
November				
December				

Source: IMF World Economic Oultook, October 2022

TABLE 3
Exchange Rates of Major countries and Selected Asian Countries: October 21, 2021 and October 21 2022 (Respective Domestic currencies per one US Dollar)

Region/Countries	2021, Oct 21	2022, Oct 21	Depreciation (%)
Eurozone (Euro)	1.16	1.05	9.48
UK (British Pound)	1.4	0.89	35.51
India (Rupees)	74.76	82.84	10.81
Australia (Aus $)	0.75	1.60	113.3
Canada (Can$)	1.23	1.39	13.01
Singapore (Sin$)	1.34	1.42	5.97
Malaysia (Ringgit)	4.15	4.73	13.98
Japan (Yen)	114.26	151.49	32.58
China (Yuan)	6.34	7.24	14.20
Russia (Rouble)	70.99	61.50	13.37
Pakistan (Rupee)	174.66	220.84	26.44
Sri Lanka (Rupee)	199.16	366.98	84.26

Source: IMF World Economic Oultook, October 2022

was further raised in May to 0.75%, and steadily thereafter by month to month by 75 basis points: in June: 1.50%, July: 2.25%; September 3.0%. (**Table 2**) The RBI too delayed its response, as it has been watching the US Fed response, although an external member of the rate setting Monetary Policy Committee (MPC), Prof Jayanth Varma was in favour of an early increase in the policy rate of interest.

The US Fed's efforts towards reducing the size of the balance sheet of US$8.97 trillion (April 2022) and four increases in the policy rate from near 0-0.25 interest rate in March 16, 2022 to 3.0% in September 2022 are now part of anti-inflationary measures. It has also been indicated that there would be more increases, at least thrice, each by 75 basis points well into 2023. These indications have led to reversal of capital outflows back to the US. Thus, in the current world, the US is a safe haven in the midst of rising global inflation. Consequently, the US dollar has appreciated by more than 13% in the last six months. **(Table 3)**

Challenges to emerging economies

This has created challenges for emerging market currencies including the Indian rupee, as well as major currencies, the yen, pound sterling and the euro, which have all depreciated considerably against the US dollar. Growing inflationary pressures have also impacted sovereign bond yields. Since August, the cost of borrowing has more than doubled for many. Monetary tightening would lead to rise in the cost of government borrowing, if the governments prioritize growth over controlling inflation.

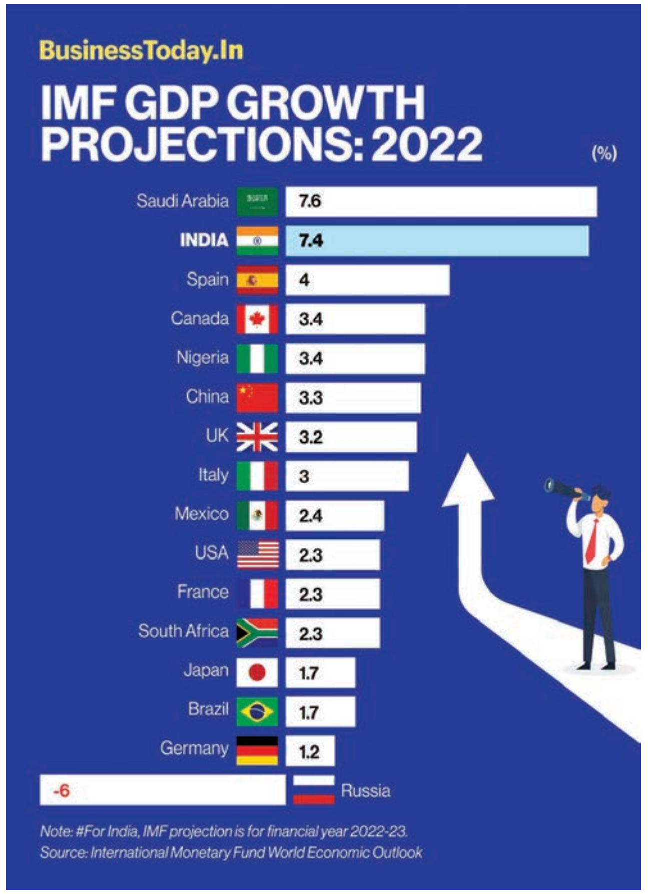
The WEO October 2022 reports, the US share in world merchandise exports is only 8%. However, the dollar's share in the payment of world exports is 40%, as prices of most of the traded commodities are denominated in US dollars. For many low-income countries struggling to reduce inflation, the weakening of their currencies has made the fight harder, as payments have to be settled in the US currency. The IMF has estimated the pass-through of a 10% dollar appreciation into domestic inflation would be around 1%. The current account deficits become larger due to rise in import costs. That made the rupee weaker. The Indian rupee touched a new low at ₹ 83 per the US dollar on October 19 and as on October 28, it is hovering around ₹ 82.74.

Would central bank intervention in the market to prop up the currency help? Or would the depreciation or free fall be allowed? As for the first, the central bank intervention, in the current situation, selling dollars would be justified only for reducing high volatility. The limit to such an intervention is determined by the availability level of the country's foreign reserves. As regards allowing a free-fall in currency values, experience indicates such a step has been found ineffective, and market players would prefer to wait for further fall. This is due to the presence of asymmetry in information to decision makers.

The IMF advice

As the IMF in its WEO October 2022 advises that in the short run, monetary policy should aim at restoration of price stability; and fiscal policy aims to alleviate the cost-of-living pressures more with direct cash transfers to the poor. Thus, the governments should have a tight fiscal stance aligned with monetary policy. Structural reforms are purely national in character. They should support the fight against inflation by improving productivity and easing domestic supply constraints.

As I write this on October 28, the US housing data released earlier in the day report that the real estate activity has contracted for the sixth straight quarter because of rising borrowing costs. However, general price pressures continue to bubble. It is not likely however that the US Fed would halt its plan to raise its interest rate. The Fed is firm in its view to anchor inflation expectations firmly. A clear message to all economic agents would be that stability is the first and foremost goal, when overall economic activities have not declined. The Fed raised interest rates five times in 2022: first starting with an increase of 25 basis points in March, 50 basis points in May, and then increases of 75 basis points in its last three meetings in June, July and September. The present rate is a target range of 3% to 3.25%. The US Fed's rate setting committee meeting on November 1-2, 2022 would raise the rate by another 75 bps to 3.75- 4.0% range.



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The European Central Bank (ECB) for 19 member countries of the Euro Zone raised its policy rate by 75 basis points on October 27 to 1.5%, the highest since 2009 with more hikes likely in the immediate future, in case inflationary pressures do not abate.

The dilemma

The RBI's Monetary Policy Committee is meeting in an emergency session on November 3, 2022. That is for entirely a different reason. The main agenda is to discuss and draft a response to the government notice why RBI missed the target rate of inflation fixed at 6% (upper limit of 4% plus a margin of 2%) for three quarters in a row. Of course, nothing would prevent the MPC from reviewing the current global situation and India's latest inflationary and growth trends. The retail inflation and industrial production data released on October 12 (inflation at 7.4% in September 2022, having risen from 7% from August; industry output growth rate contracting by 0.8$) were not before MPC, when it met on September 30. Now that MPC meets in an emergency session on November 3, it can consider whether any upward revision is needed. It is now for the Governor to decide on the dilemma : Which one would merit priority attention: Growth or Stability. ■

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