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Is RBI going to get a notice on inflation?

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The data on India's consumer index (CPI) based inflation for July, known as retail inflation and wholesale price index (WPI) based inflation, both calculated on a year-on-year basis were released on August 12 and 16, respectively. Both were published only after the Monetary Policy Committee (MPC) of Reserve Bank of India (RBI), which met on August 3-5 to set the interest rate for next two months. So, MPC members were unaware of the mounting challenges the economy faces in the month of completion of the 75th year of political independence.

The retail inflation (6.71%) in July eased from the June figure (7.1%). However, the tolerance level, defined as the target rate (4%) agreed to between government and RBI plus an upwardly allowable margin of 2%, totaling 6%, has been breached for the seventh consecutive month since January. Inflation worries continue as it is above 6%

This was the despite an increase of 40 basis points (bps) by a regular bimonthly meeting in MPC in May and another 50 bps by emergency meeting in June, in all taking the policy rate from 4% to 4.90% as part of moving away from expansionary phase for fighting the Covid-19 induced recession since mid 2020. Seeing the need for another rise in interest rate, the August MPC decision to raise it further to 5.40%, higher than the pre-Covid interest rate of 5.15% was an extraordinarily hawkish step. The RBI governor christened it as " the new normal".

Too late a realization?

Tobias Adrian and Fabio Natalucci of IMF wrote in their blog on August 10, 2022 that central banks of both advanced and emerging market economies which supported the economic recovery in the face of Covid-19 induced recession, with interest-rate cuts and asset purchases changed their gears quickly soon after inflationary pressures rose on the horizon. They observed: "With inflation at multi-decade highs in many countries and pressures broadening beyond food and energy prices, central banks have pivoted toward tighter policy in many emerging markets proactively started to hike rates earlier last year followed by their counterparts in advanced economies in the final months of 2021".

There were two notable exceptions; the US Federal Reserve (the Fed) until March, and RBI until May, both 2022. The Fed's inflation has been way off the target rate of 2% for more than a year, From 5.3% in August 2021, inflation steadily rose to 7% in December and reached 9.1% in June 2022. Just as Indian inflation cooled off in July following fall in prices of commodities including food grains and edible oils as supply situation slightly improved with a decreasing trend in petroleum crude prices, though with volatility due to fear of recession, the US inflation fell to 8.5% in July.

The US Fed was resisting any rise in interest rate all along by arguing that factors influencing the rise in price level were transitory. The US Fed chair admitted much earlier, on November 30 2021 in his testimony to the US Senate Banking Committee that it was time to quickly wrap up the large scale purchase of bonds which was pumping up money supply, he took time to realize the unmistakable sign that world economy was recovering from the Covid-19 recession, as crude price was rising.The Ukraine-Russia war which broke out in February 2022 triggered the Fed's tightening stance. Growing disruptions in supply of crude, natural gas and food grains, as Ukraine was a leading wheat exporter, resulted in increase in commodity prices. That is the second, so called Black Swan event, the first one being Covid 19. The US Fed raised the rate only in March.

The RBI was also using term " transitory and transient factors" for a while and delayed the tightening of easy monetary policy. Only in last May, RBI India began a series of anti-inflationary measures with a small rise by 40 bps in May, 50 bps in June and another 50 bps in August, in all 140 bps since May.

Should RBI have acted earlier?

That is the question which would be formally examined, in the event of a persisting inflation above the tolerance level in August and coming September. Under the RBI Act, if inflation is above 6% for three consecutive quarters or nine months beginning from since January 2022, the central government can ask why monetary authorities failed to keep inflation below 6% . The notice would however create an awkward situation for the government too, raising the question whether the government interfered with central bank autonomy. It remains to be seen if such a notice gets issued at all.

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