RBI Rate Hike: Inflation-Hit India Needs Sound Policy, Not Hawkish Measures

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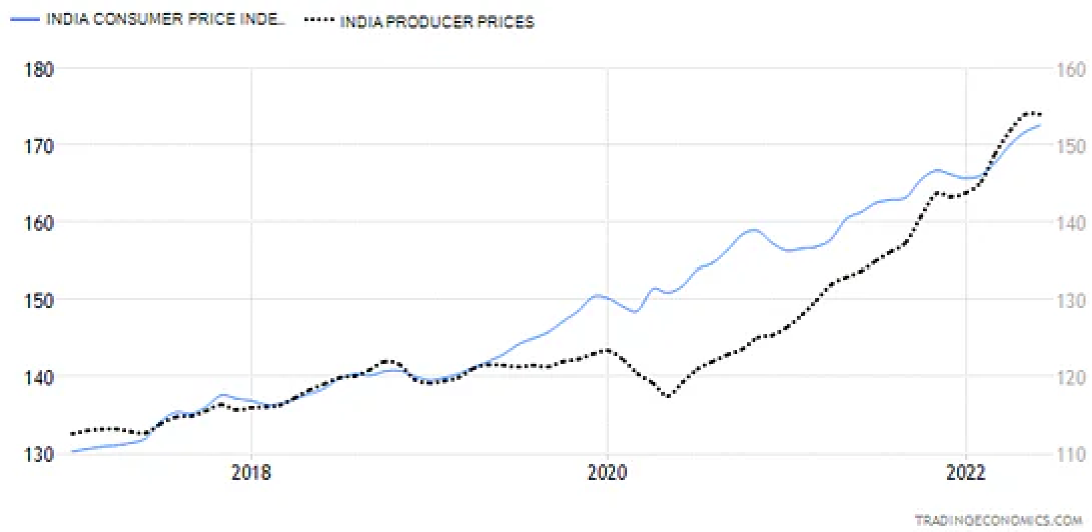
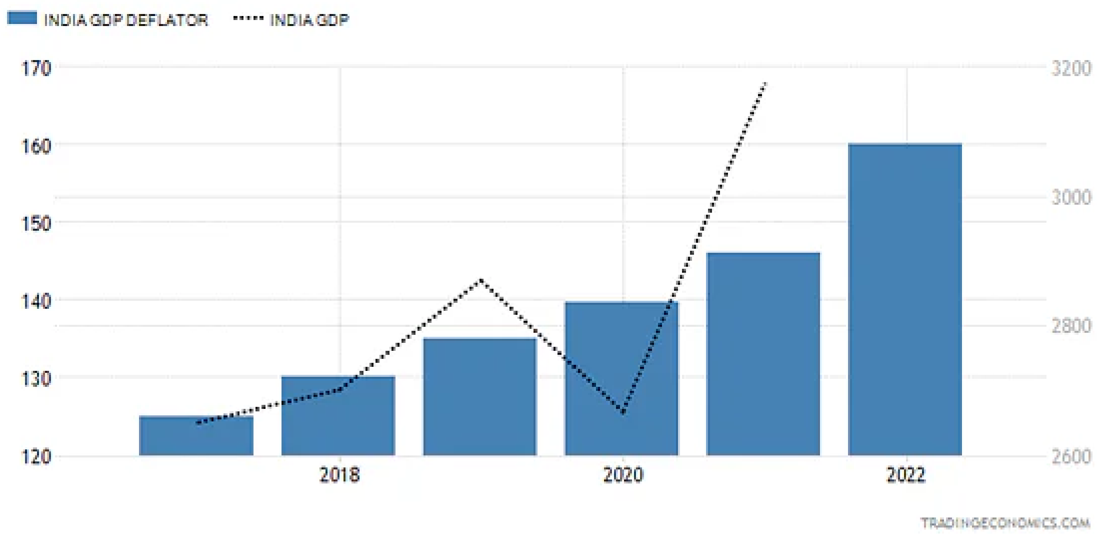
The Reserve Bank of India (RBI) raised its key interest rate by 50 basis points this Wednesday, taking the repo rate to 4.9% while raising its inflation projection for the current fiscal to 6.7%, well above the upper end of the central bank's target range of 2% to 6%. Analysts also expect the RBI to reduce liquidity, reinforcing its fight against inflation and extending its effort to return monetary conditions to what they were like before the COVID-19 pandemic, which led to radical action to stimulate the economy.

In simpler times, the RBI's hawkish monetary policy stance will further push short-term borrowing costs higher, as loans, credit card payments and all other business-personal lines of credit from banks become costlier. This is at a time when retail and, particularly, wholesale inflation (producer prices) figures have been soaring across India, as also in most countries across the globe (see Figure below).



Don't Fall for the GDP Numbers

India's recent growth performance in comparison to the past also has strong indications of an 'inflation-fueled' growth trajectory. This is worrisome. Inflation-adjusted GDP numbers show how most of the increase in recent growth numbers may have happened as a result of higher prices (including net exports) and why they may be less indicative of an increase in productivity, production output (or income). Figures on the GDP deflator below also reflect this.



The RBI as a central bank has a mandate to target and keep inflation levels low. It has beenargued in the past how the RBI erred in perceiving inflationary threats without embarking on a tight inflation-targeting monetary policy response over the last year and a half. The realisation of this mistake is evident in its recent course-corrective measures, which will impose liquidity costs for essential borrowing-lending.

> A rise in 50 basis points for short-term interest rates is consistent with the central bank's monetary policy measures observed across the globe, ie, from the US Federal Reserve to the Bank of England.

Having said so, India's own macro-economic position and its deeply stratified socio-economic landscape warrant – and merit – a different economic policy response to rising prices, which, under high inflation, impose a high 'invisible tax' on the poor and the less economically mobile communities. Monetary policy alone may not help in dealing with inflation and its impact on MSMEs, lower-income groups and the poor. I have been saying this for over two years now.

Small Firms are Going Out of Business

Even if we set concerns about rising inflation and its impact on consumers aside for a second, and see how this is going to impact the small- and medium-scale business landscape, the situation looks very grim. The wholesale inflation level, which measures the aggregate level of prices for producers (including for raw materials, etc), has been in double digits for over two years now. What this reflects is how input and output costs for most produced goods and services are growing with every passing month, and how the MSMEs' ability to afford higher costs remains weak given thatmore than 60-70% of these firms are neck-deep in debt. All of this has been happening at a time when real demand amongst middle-and lower income groups has remained compressed for a few years now, indicating a Keynesian-style aggregate demand problem.

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Many micro and small firms are going out of business, which has spill-over effects on overall productivity and the job crisis. Note how MSMEs in India contribute to more than 60% of the total workforce and make up for more than 30% of India's GDP (and almost 50% of exports). During the lockdown, the lack of effective fiscal support and targeted interventions from the Union and state governments made many MSMEs shut shop.

(Un)Employment Situation Can Worsen

Subsequently, a high wholesale inflation-triggered cost of production rise, combined with the RBI's monetary policy tightening measures (via increasing short-term interest rates) are cornering even more MSMEs now. In the months ahead, this is likely to drive more of these firms out of business,which will make the employment situation for those struggling to find 'decent' jobs go further down south. That's my principal concern.

> Even firms – especially with higher capital and reserve cash and liquidity – that can afford to stay afloat in such a time and produce will pass on the 'high input-output costs' to consumers, expecting them to pay more.

Do note, though, that with GST rates continuing to expand as a regressive indirect tax on all consumers, inflation and a tightened monetary policy stance will continuebeing an 'invisible tax' on the citizenry.

What Can – or Must – the Government Do?

Well, as a first, maintaining that 'price rise' is a non-issue and that 'unemployment' isn't a concern for the economy will not help. Ministers in the current government, including the Prime Minister himself, have been living in denial for far too long now, which is worsening the macro and micro-economic outlook. Business sentiment is weakening further as corporates may soon realise the ineffectiveness of government policy in fixing structural issues. The Finance Minister, in her official statements in Parliament and outside, has repeatedly defended and justified the government's (in)action as being the right and appropriate move.

Also Read

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There has been hardly any concentrated policy action undertaken to either respond to high retail inflation or high wholesale inflation – forget about any other issues connected to these. The longer the government lives in a state of denial, the worse the economic situation may turn. The RBI's solitary moves may not be enough to either keep overall prices low or minimise the spillover costs of that and its own policies.

The Cost of Inaction Can Be Huge

Whetherit is MSMEs orlow-income groups, both need fiscal support through phased-out, short, medium- to longer-term measures of targeted fiscal interventions. Yes, the roadmap for introducing such 'targeted fiscal spending' might create or triggerperceptions of debt-fuelled spending woes, at a time whenpublic debt is already high for most states. Also, this would happen when the macro-fiscal deficit seems to go higher with any such new measures. However, the cost of not doing anything or living in denial is far more.

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Creatingmedium- to long-term fiscal support plans for income support for the poor, social security-backed employment generation (perhaps through an Urban-NREGA), and designingMSME credit-backed guarantee plans in coordination with the RBI may help the government in both increasing the confidence of producers and enabling consumers

across all income groups to spend. This will allow for a net higher aggregate consumption that shall boost demand, while also creating more incentives for small, micro and medium-scale enterprises to produce more and hire more.

As of now, party politics is directing the overall narrative of ‘price control’ and the government is skirting around a sound economic policy response. Together, this may push the economy into a dark, slithering, unchartered territory.

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