THE PARTY IS OVER

To stall price spiral, RBI is likely to respond with aggressive hikes

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DATA RELEASED BY the National Statistical Office showed that retail inflation had surged to an eight-year high of 7.79 per cent in April, driven by higher food and fuel prices. The former rose to 8.38 per cent driven by double-digit inflation in edible oils and vegetables, while inflation in cereals surged in April because of higher wheat prices. Inflation has now remained above the RBI's upper tolerance limit of 6 per cent for four months in a row.

The second-order impact of higher fuel prices is also visible as inflation in transport and communication surged to nearly 11 per cent, from 8 per cent in the previous month. The April data again showed that rural inflation outpaced urban inflation as the rural consumption basket gives more weightage to food. This is not good news for rural demand, which is yet to show a sustained pick-up.

The latest data also indicates that inflation is becoming broad-based. With the lifting of Covid restrictions and a pick-up in demand, services sector inflation captured by the "miscellaneous" category has surged to 8.03 per cent. And with demand rebounding, the pass-through of higher input costs is also gaining momentum. Considering that demand for goods recovered faster than services, goods producers passed on input costs to consumers. But as services recover, there will be greater pass-through of prices to consumers in the coming months. Concerns about rising services inflation were also reflected in the April S&P Global Purchasing Managers' Index survey for India's services sector. The surveyed service providers highlighted a sharp surge in their operating expenses from March to April prompting them to pass the impact of rising input costs to consumers.

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While there may be a slight moderation, inflation is expected to remain above the RBI's threshold of 6 per cent in the coming months. While global food prices measured by the FAO's Food Price Index eased marginally in April, they are still 30 per cent above that in April 2021. The Ukraine conflict continues to impact markets for foodgrains and vegetable oils. Rising fertiliser prices are likely to push up farmers' production costs, leading to high food prices. While the government has extended price support through higher subsidies, if this will be enough to cool prices needs to be seen.

With sticky crude oil prices and continuing supply-side disruptions amplified by the Covid-induced lockdowns in China, the RBI has rightly reverted its focus on inflation targeting. This is needed as central banks around the world are pursuing tight monetary policies to counter inflation. The US Fed followed its 25 basis points hike by another 50 basis points rise in May. These will be followed by hikes of similar magnitude in the coming months. The Bank of England has raised the policy rate by 25 basis points, its highest in 13 years to tackle inflation. Other countries' central banks are also contemplating rate hikes.

In its April policy, the RBI announced the withdrawal of excess liquidity but did not raise the policy rate. The expectation of a sharp spike in inflation led it to announce an off-cycle 40 basis points hike in the policy repo rate. The RBI is now likely to respond with aggressive rate hikes to prevent the price spiral from getting entrenched. By committing to bring down inflation through rate hikes, it bank can anchor inflationary expectations. Unanchored expectations will further fuel inflationary pressures. The continued strength of the dollar index and sharp rupee depreciation in the last few days could impose further pressure on prices through higher imported inflation. This reinforces the need for interest rate hikes.

In addition to calibrated rate hikes, the RBI needs to fast-track the withdrawal of the ultra-accommodative liquidity support provided during the pandemic. It needs to present a revised projection of inflation for the current year and its views on the possible trajectory of interest rates. Rising inflation will cut back discretionary spending and adversely impact consumption that had only just started picking up. There are concerns about a recession in advanced economies as rising prices have started manifesting in a decline in purchasing power and a fall in consumer sentiments. The demand destruction could trigger a moderation in prices. Base metals prices have eased from the peak seen in the last few months.

Monetary policy support needs to be accompanied by fiscal support measures. The policy response will have to be tailored to the evolving geopolitical situation and the paths of commodity and food prices while balancing the imperatives of fiscal consolidation.

The writer is senior fellow, NIPFP. Views are personal