Quickonomics

August 13, 2021

From status quo, quo vadis?

All signs point to the beginning of the end of easy money policies across the globe. The only question for the Reserve Bank of India (RBI) is of timing.

An uneasy calm prevails in the global markets. That's because, while central banks of major economies have continued to pursue easy monetary policies to stimulate growth, there has been a sharp rise in inflation.

Systemically important ones, including the US Federal Reserve (Fed) and the European Central Bank (ECB), see this rise as transitory, and have chosen to tweak policy to become more inflation-tolerant. In emerging markets, some are moving ahead of the Fed in tightening, while others are staying accommodative.

The Reserve Bank of India (RBI), too, has been tolerant of inflation, with its Monetary Policy Committee (MPC) staying accommodative to support growth.

But the easy regime appears to be reaching its limit. The latest MPC actions signal so.

We expect the RBI to make a more definitive statement by this fiscal end, and raise rates by ~25 basis points (bps).

While inflation will be the key driver of this decision, other factors such as the strength of recovery (mainly domestic demand) and policy normalisation by other major central banks will also matter.

In this edition of Quickonomics, we take note of key global central bank actions this year. We also analyse how inflation has fared in these economies relative to the tolerance band of their central banks. We then discuss our expectation on monetary policy action by the RBI.

Whither monetary policy normalisation?

The MPC stood pat in the latest review, but in an interesting departure, announced a small increase in the absorption of surplus liquidity through variable rate reverse-repo operations.

With this, the RBI joined other central banks that are on course to gradually unwind the year-long stimulus to fight the pandemic.

According to S&P Global[1], the 'tapering' or reduction in bond purchases by the Fed could come as early as end of calendar 2021.

Central banks in Brazil, Russia, Turkey and Canada have already moved to taper or hiked policy rates, influenced by inflation.

The nature of inflation, coupled with the tolerance for it, has defined central bank actions this year.

The early movers

About eight major central banks have begun monetary tightening. While some have bitten the bullet and hiked policy rates, others have begun to taper asset purchases (see Table 1).

Broadly, Latin American economies (all inflation-targeting) have hiked rates in response to inflation rising beyond their respective targets.

Among other countries, Russia and Turkey faced the challenge of reining in inflation expectations. Meanwhile, smaller advanced economies like Canada and New Zealand have begun tapering in response to improving economic outlook and to prevent unsustainable rise in asset prices.

[1] *S&P Global (July 2021). The Fed Inches Closer To Tapering, But Says Little About Balance Sheet Normalization*

Table 1: The heat is on for these central banks

Country	Monetary policy action 2021 (till August)	CPI inflation (Apr-June 2021)	CPI inflation (Jan-June 2021)	Inflation target
Brazil	325 bps rate hike	7.8%	6.5%	3.75% (+/-1.5%)
Russia	225 bps rate hike	6.0%	5.8%	4%
Turkey	200 bps rate hike	17.1%	16.3%	5% (+/-2%)
Mexico	25 bps rate hike	6.0%	5.0%	3% (+/-1%)
Chile	25 bps rate hike	3.6%	3.3%	3% (+/-1%)
Canada	Tapering of QE since April 2021	3.5%	2.4%	1%-3%
New Zealand	Halt of additional asset purchases from July 2021	3.3%	2.4%	1%-3%
Australia	Tapering of QE to begin from September 2021	3.8%	2.5%	2%-3%

Note: QE - quantitative easing
Source: Central banks and statistical bureaus of respective economies, International Monetary Fund, CRISIL

Rate hikes | Tapering of asset purchases

Table 2: Next in the tapering line

Central bank	Monetary policy expectation for 2021	CPI inflation (April-June 2021)	CPI inflation (Jan-June 2021)	Inflation target
US Federal Reserve	S&P Global expects tapering to begin by the end of 2021.	4.9%	3.4%	2%
European Central Bank	S&P Global believes some tapering of pandemic emergency purchase program could begin by the end of this year.	1.8%	1.4%	2%

Source: Central banks and statistical bureaus of respective economies, International Monetary Fund, CRISIL

At inflection point

The Fed and ECB are being patient. They continue to keep policy rates and bond buying programme unchanged to stimulate growth.

We could see them tapering by end of the year if recovery gains momentum, but policy rates could stay put for a while (Table 2).

Though the Fed faces the risk of inflation running much higher than target, its new policy framework (targeting an average of 2% inflation over the long run), allows for temporary overshooting. The recent surge in Covid-19 cases is also a monitorable.

How are inflation drivers different in India?

Though inflation is a worry for both the US Fed and the RBI, there are some differences between the underlying drivers, influencing the tolerance thresholds:

1. Base effect: India's consumer price index (CPI)-based inflation this fiscal comes on top of an already high base of the previous, unlike in the US. We forecast India's CPI inflation at 5.8% this fiscal over an above-the-tolerance-band rate of 6.2% last fiscal. In contrast, US' inflation is projected at 3.6% for calendar year 2021, over 1.2% in 2020.

2. Transience of inflation: India's inflation has a transitory component from the pandemic-induced supply disruptions, which is expected to reduce as the economy recovers.

   However, higher fuel prices and increased pass-through of rising input costs by firms to consumers are expected to keep inflationary pressures high. That could accelerate as domestic demand recovers in the second half of this fiscal.

   Inflation expectations have also been rising since March and if this continues, it would add pressure on the MPC to normalise policy.

   In contrast, a large component of the inflation in the US is seen as transitory, driven by a low base, supply bottlenecks, and pent-up demand.

   While persistent supply bottlenecks might hold inflation high in US in the coming months, these pressures are expected to ease once production of critical inputs such as semiconductors catches up with goods demand.

For India, inflation will remain a persisting concern driven by elevated global commodity prices. Global prices of metals and edible oils are at decadal highs, while Brent crude oil prices are above the $70 per barrel mark – the highest since 2019.

What action can we expect from the RBI?

The RBI has been tolerant of inflation and has stayed accommodative to support growth given the deep hit suffered by the economy.

But it appears to be reaching the end of tether as inflation naggingly ascends.

If this pressure continues and systemically important central banks, especially the Fed, begins normalising, the RBI will start to roll back accomodation.

Despite weak domestic demand, inflation in India has been stubbornly high, at times breaching RBI's upper tolerance band of 6%.

At its last meeting, the MPC revised upwards its forecast for CPI inflation to 5.7%, in a sign of what is to come.

Economic recovery, which is expected to gain momentum in the second half of this fiscal, will further reduce the need for extremely accommodative policy.

For now, the RBI is taking baby steps towards the exit. We expect this calibrated withdrawal of liquidity to continue and gain pace as more certain signs of economic recovery become visible.

But that is predicated on growth staying on track. We expect a two-stage signaling by end of this fiscal: a change in stance from accommodative to neutral, followed by a hike in the repo rate by 25 bps to 4.25%.

Appendix: Central bank actions and inflation drivers across economies

Central bank	Policy stance and expectation	Policy rationale	Average CPI inflation (Apr-June 2021)	Average CPI inflation (Jan-June 2021)	Inflation target	Drivers of inflation
US Federal Reserve	Fed rate and bond buying programme unchanged so far S&P Global expects tapering to begin by 2021-end and last for a year. First rate hike is expected in early 2023.	Fed seeks to achieve maximum employment and inflation averaging 2% over the long run. Given inflation has consistently undershot this target in the past, the Fed will allow inflation to run moderately above 2% for some time. Large part of the recent spike in inflation is viewed as transitory	4.90%	3.40%	2%	Low base effect from last year, supply bottlenecks, heated goods demand, and strong reopening of services sector
European Central Bank	Policy rates and QE unchanged so far S&P Global does not expect rate hike before late 2024, but some tapering of asset purchases might begin from September 2021	Inflation is expected to remain below ECB's target over the medium term	1.80%	1.40%	2%	High energy prices have driven the recent rise. While input cost pressures have risen for firms, ability to pass-through to consumers remains limited. However, core inflation remains muted

Central bank	Policy stance and expectation	Policy rationale	Average CPI inflation (Apr-June 2021)	Average CPI inflation (Jan-June 2021)	Inflation target	Drivers of inflation
Bank of England	No change in policy rates and QE so far. S&P Global expects it to start raising rates only moderately from late 2023	BoE expects that the economy will experience a temporary period of strong GDP growth and above-target inflation, after which both will subside	2.00%	1.30%	2.00%	High international commodity prices and supply bottlenecks
Japan	Unchanged policy rate and quantitative and qualitative easing with yield curve control. S&P Global expects policy to remain largely unchanged	Japan continues to face deflation, while growth faces downside risk from rising Covid-19 cases	-0.1	-0.30%	2.00%	While energy prices have added some pressure, weak consumption demand has kept overall inflation muted
Canada	While keeping policy rates unchanged, Bank of Canada has been tapering its QE purchases since April 2021	Continued progress on economic recovery amid high rate of vaccinations, with inflation remaining above target, has prompted policy normalisation	3.50%	2.40%	1-3%	Rising energy prices and other supply side pressures, driving a broad-based rise in inflation
New Zealand	Central bank will halt additional asset purchases from July 2021. Policy rate remains unchanged.	The central bank no longer felt the need for additional QE purchases given market conditions and improved functioning. Moreover, unsustainable rise in house prices was a concern.	3.30%	2.40%	1%-3%	High oil prices and transportation costs
Australia	Policy rate kept unchanged. Quantum of bond purchases will be reduced from September.	Economic recovery has been faster than expected earlier. The hit from current Covid wave is expected to be temporary.	3.8%	2.5%	2%-3%	Low base, unwinding of some earlier Covid-related price declines, and rising commodity prices contributed to rise in inflation.
China	Financial conditions had already begun tightening since the second half of 2020. S&P Global does not expect further tightening in 2021	Inflation is not a significant threat as pass-through from producer to consumer prices remains low. Consumer confidence remains weak	1.10%	0.50%	3%	While producer prices have risen significantly, pass-through to consumer prices remains weak, given lacklustre consumer confidence, high saving and low spending

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Central bank	Policy stance and expectation	Policy rationale	Average CPI inflation (Apr-June 2021)	Average CPI inflation (Jan-June 2021)	Inflation target	Drivers of inflation
Brazil	Policy rate has been raised by a total 3.25% in 2021 so far. S&P Global expects central bank to continue raising rates till 2022	Monetary policy aims to rein in inflation which is running much beyond target.	7.80%	6.50%	3.75% +/- 1.5%	Rising commodity prices, impact of fiscal stimulus, supply-demand mismatches and depreciating currency
Russia	Policy rate hiked by 2.25% this year. S&P Global expects monetary policy to remain tight through the year	Persistently elevated inflation and rise in inflation expectations has led to the tightening	6.00%	5.80%	4.00%	Recovery in demand and supply bottlenecks, coupled with pass-through from weaker currency, contributing to broad-based rise in inflation
Turkey	Policy rates hiked by 2% this year. S&P expects a sustained downward inflation trend to allow policy easing in second half of the year	The central bank aims to keep policy rate above inflation until strong indicators point to permanent fall in inflation towards target	17.10%	16.30%	5% +/- 2%	Rising commodity prices, exchange rate depreciation and high inflation expectations contributing to double-digit inflation

Source: Central banks and statistical bureaus of respective economies, S&P Global, CRISIL

Rate hikes | Tapering of asset purchases | No action so far

Analytical contacts

Dharmakirti Joshi
Chief Economist
dharmakirti.joshi@crisil.com

Dipti Deshpande
Principal Economist
dipti.deshpande@crisil.com

Pankhuri Tandon
Economist
pankhuri.tandon@crisil.com

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited /lifeatcrisil

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