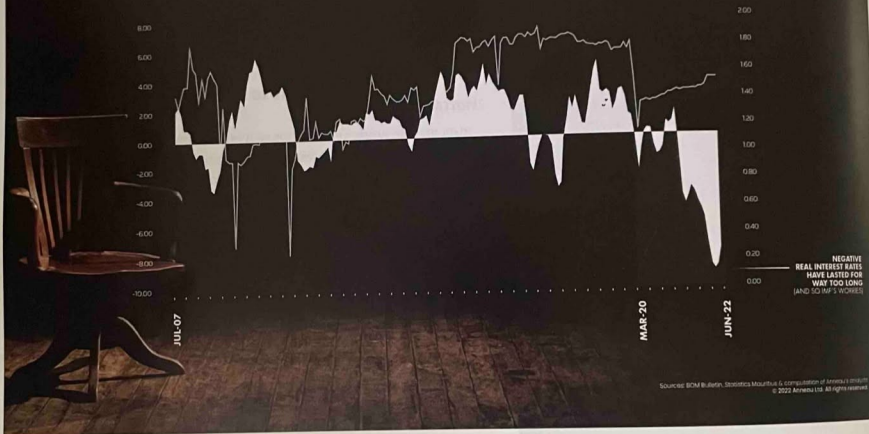


THE CONUNDRUM OF MONETARY POLICY

A delicate balancing act

Persistent Negative Real Interest rates are impoverishing

Negative Real Interest rates (Left Hand Scale, in %)
Key Repo Rate & Weighted Average Rupee Deposits Rate of Banks Spread (Right Hand Scale, in %)



BY NOW, it is of no surprise that the world has embarked on a global monetary policy tightening to counter inflationary pressures. Not only are central banks around the world on an 'aggressive' tightening path but the pace of tightening, globally is at its most rapid pace since the 2000's (for the US, they have tightened at the fastest pace since 1994!). So yes, inflation has finally turned out to be a major worry (as Anneau had rightly anticipated since March 2020! – How, well everything was cooking up in this direction). From a risk management perspective, restarting the economic machine after months of lockdown was bound to create global supply chain disruptions and under supply, coupled with heated up private and public consumption (the massive US infrastructure bill adds to the commodity party boom

as well). The extent of the damage however had not been priced in – War!).

This global tightening cycle is primarily to indeed contain inflationary pressures, which are invariably impoverishing, for the world's poorest. How much and at what pace to tighten requires a lot of intellect and skills but also the proper monetary policy and their transmission tools. Balancing the considerations of economic growth and inflation is always an intellectual headache for Central Bankers and policymakers around the world.

Getting it right, however, takes much more.

As such, "Monetary policy is like juggling 6 balls... it is not 'interest rate up, interest rate down'. There is the exchange

rate, there are short-term yields, there is credit growth." Raghuram Rajan.

Global rates rising fast: a monetary phenomenon

Since the past 3 months, we note that roughly 85 countries out of the 168 countries monitored have tightened their interest rates (by an average of 1%). The United States' Federal Reserve has already hiked by 1.50% while the European Central Bank tightened by a surprising 0.50% in late July 2022 (for the first time in almost 12 years); thereby marking an end to this prolonged era of negative to low interest rates.

Elsewhere, Japan continues to stay put while China had to loosen its money

tary policy by 10 basis points to 3.7% as the COVID-19 lockdowns and economic slowdown supported such a policy move. Brazil has already hiked 10 times since March 2021.

The developed and emerging economies are relatively massive as opposed to our domestic economy. The interest rate differentials and the pace of rates normalization domestically, however, remain worrying as we increasingly and 'strangely' lag.

Even the IMF now recommends urgent tightening

The IMF staff in its country consultation paper clearly recommends that (and we quote) "the **BOM actively tightens** the policy stance to control inflation and counter un-anchoring of inflation expectations and second-round effects: Inflation was already on the rise post-COVID due to supply chain bottlenecks, increasing transportation costs, and higher commodity prices. The war in Ukraine led to new pressures in the global commodity markets. This worsened the outlook for domestic inflation and increased the risk of un-anchoring inflation expectations and second-round effects if higher expectations are priced in nominal wages. **A continued recovery may further increase domestic cost pressures.**

Policy tightening does not need to wait for the roll-out of the new policy framework. While the new framework would allow for better management of interest rates, the BOM could deploy the existing framework **in the interest of timely action.**

It could mop up excess domestic cash reserves in full through the issue of BOM bills at a rate that induces the money market rate to align with the operational target (the announced policy rate). The maturity of BOM bills could be reduced from 3 months to 7 days to make operations more effective. The pace of policy rate adjustment should depend on the macroeconomic and inflation outlook and aim to bring inflation back to its medium-term target over the monetary policy horizon.

Increasing the announced policy rate and not fully transmitting it to the money market rate by means of open market operations will not suffice for tighter conditions."

The BOM remains way behind the curve

We, at Anneau, have been hawkish since the past 2 years and in all humility, reiterate that the policymakers tighten as quickly as possible and to the tune of at least 50 basis points a month, such that the KRR ('Key Repo Rate') hits at least 4.25%.

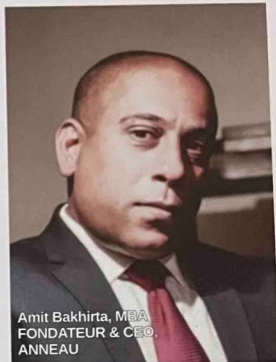
With Q122 GDP growth having recovered to +8.7% (yes, low-base effect of Q121 and a commendable recovery in Food service & accommodation), the room for tightening is comfortably 'ample'. Should inflationary pressures abate into the last quarter of the year (we already note that following the 'Black Sea initiative' agreement signed by Russia and Ukraine – to resume exports of grains and fertilizers, soft commodities prices have weakened by circa -21% since May 2022 – and we expect this weakness in global soft commodities prices to gather momentum into the end of year!), rates can be adjusted downwards, thereafter, as need be.

However, the longer our monetary policy tools are underutilized, we risk rendering the same tools sterile and the monetary transmission mechanisms are likely to grow increasingly inefficient – exacerbated by the weakness of the Central Bank's balance sheet.

This supports the IMF's views in this regard: "Consistent with the BOM Act, the **government needs to cover the BOM's losses which may materialize due to increasing policy implementation costs already in the near- to medium-term.**

The BOM accounted the transfer to the government in 2021 as a dividend by exhausting the special reserves fund (SRF) of its accumulated valuation gains.

The BOM capital is relatively low at Rs10 billion (about 2 per cent of both GDP



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and BOM liabilities), which limits resources to sustain policy costs at higher interest rates and increased sterilization amounts.

In staff's baseline projections, inflation normalizes by 2025 assuming policy is tightened appropriately. A key risk to the outlook is delayed or incomplete tightening. This may happen if the government signals. It also complicates the official reserve adequacy assessment unwillingness to increase the BOM's capital and the BOM decides to limit expenses on domestic liquidity sterilization.⁶ Delayed tightening will inspire un-anchoring expectations and more inflation in the alternative scenario. Recapitalizing the BOM upfront is preferable to address the risk and create buffers in advance, but it is also more demanding for the fiscal sector.⁷ The Rs5 billion (1 per cent of GDP) in the BOM's accounts receivable should not be transferred to the government to limit further deficit monetization."

While we are cognizant of the quantum of imported (supply side) inflation via high global commodity & international freight prices, a historically weakened Rupee and domestic monetary policy's vulnerability in addressing supply-side inflationary pressures, we stick to Milton Friedman's "inflation is always a monetary phenomenon" and argue that demand and consumption needs to be tackled (and the only way to do so is via a much tighter monetary policy instance) and so the quantum and velocity of money shall be impacted in the manner so as to dampen consumption in the domestic economy; thereby helping it to cool off, in a controlled and disciplined manner.