Central Banks' Actions - Need for Caution

What is the issue?

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- There has been a series of central bank actions across the world in the past few days.
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- The emerging trend in this regard needs appropriate attention and policy response.
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What are the recent developments?

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- The Federal Open Market Committee (FOMC) of the US Federal Reserve went ahead a policy rate hike recently.
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- Across the Atlantic, the European Central Bank (ECB) has stated its intention to end its Quantitative Easing (QE) programme soon.
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- India's central bank has announced an enhanced QE of its own from January, 2019.
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How does the future look?

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- The Fed rate hike was the fourth in the calendar year 2018 and the ninth since December 2015.
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- But the US central bank now projects only two rate hikes in 2019 (as against three expected earlier).
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- It's because it sees US GDP growth rate easing even as inflation moderates.
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- The ECB will stop its QE, by which it has been buying €15 billion worth of bonds every month.
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- It has thus injected over €2.6 trillion in liquidity since March 2015.
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- The ECB will reinvest the proceeds of those bonds as they mature.
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- Also, there is Fed’s rate hike and ongoing steps of quantitative tightening.
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- Together, these imply a tighter liquidity scenario for hard currencies in 2019.
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- One likely consequence is lower foreign portfolio investor (FPI) commitments to emerging markets.
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- In particular, this could mean sales by foreign portfolio investors (FPI) of rupee debt holdings as well as equity outflows.
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What is the case with India?

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- The Reserve Bank of India (RBI) has eased the liquidity conditions, but has held policy rates stable despite lower inflation figures.
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- From January 2019, the RBI intends to buy Rs 600 billion worth of bonds every month in open market operations (OMO), effectively injecting that much liquidity.
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- The current liquidity deficit in the Indian banking system is estimated at Rs 1.3 trillion.
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- The widening of the liquidity deficit can be attributed to the higher fund demand by corporates to meet the advance tax payment deadline of December 15.
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- [Advance tax/'pay as you earn tax' means income tax should be paid in advance instead of lump sum payment at year end.]
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- This could be exacerbated by higher government borrowings, with the fiscal deficit target already exceeded.

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- In this backdrop, the central bank will be under pressure to cut rates at the coming meetings.
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- The headline inflation rate is down well below the targeted 4% year-on-year trend of the consumer price index (CPI).
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- This is due to negative changes in the food basket (which contributes 46% of the CPI by weight) and moderating fuel prices.
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- So there’s a case for a policy rate cut.
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What is the need for caution?

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- Despite the above, the RBI has to consider the fact that core inflation (excluding food and fuel) is high at about 5.75%.
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- It must also track the potential impact of rate changes on the rupee.
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- If the dollar and euro rates go up, as they will, and rupee rates go down, the rupee could experience another spell of weakness.
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- The dollar may strengthen and continue to put pressure on emerging market currencies in particular on account of the rate hike.
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- This will also affect investors looking at these markets as the currency risk increases.
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- Also, as OMO expansion indicates, there is already a liquidity deficit.
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- So by stimulating consumer demand, a lower rate could lead to an increase in the liquidity deficit, driven by further drain of resources.
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- Also, banks with stressed balance sheets may not be willing, or capable, of passing on rate cuts to commercial borrowers.
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- In all, the RBI must consider bond market conditions, rupee movements and changing inflation projections before it decides on rates.
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Source: Business Standard

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