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RBI Bulletin – January 2025

Today, the Reserve Bank released the January 2025 issue of its monthly Bulletin. The Bulletin includes seven articles and current statistics. Report on Trend and Progress of Banking 2023-24 and Financial Stability Report December 2024 are supplements to the January 2025 Bulletin.

The seven articles are: I. State of the Economy; II. Measuring Monetary Policy Communication: The Indian Experience; III. Foreign Exchange Intervention: Efficacy and Trade-offs in the Indian Experience; IV. A Suite of Approaches for Estimating Equilibrium Exchange Rates for India 2.0; V. Geopolitical Risk and Trade and Capital Flows to India; VI. Financial Stocks and Flow of Funds of the Indian Economy 2022-23; and VII. Fiscal-Inflation Nexus: Is there a Feedback Loop?

I. State of the Economy

The economic outlook for 2025 is divergent across countries with some loss of speed in the US; weak to modest recoveries in Europe and Japan; more moderate growth profiles in emerging and developing countries alongside a more gradual disinflation relative to advanced economies. In India, there is a conducive quickening of high frequency indicators of economic activity in the second half of 2024-25, bearing out the implicit pick up in real GDP growth for this period in the annual first advance estimates of the NSO. Headline inflation eased for the second successive month in December, although the stickiness in food inflation warrants careful monitoring of second order effects.

II. Measuring Monetary Policy Communication: The Indian Experience

By Michael Debabrata Patra, Shweta Kumari and Indranil Bhattacharyya

This article examines the Governor’s statements and the subsequent press conferences on the monetary policy announcement day using natural language processing (NLP) techniques. It highlights the role of communication in managing expectations, especially during crisis episodes.

Highlights:

- The policy communication strategy has evolved in response to the emerging economic conditions and uncertainty as reflected in changing emphasis on various topics deliberated in Governor’s statements.
- Press conferences have served as a key communication channel for clarification and reinforcement of policy decisions.

- Meticulously crafted Governor's statements with selected and emphasised words have instilled confidence in Indian financial markets during adverse and uncertain periods.

III. Foreign Exchange Intervention: Efficacy and Trade-offs in the Indian Experience

By Michael Debabrata Patra, Sunil Kumar, Joice John and Amarendra Acharya

The article evaluates the effectiveness of forex interventions by the Reserve Bank of India (RBI) in containing the exchange rate volatility in India.

Highlights:

- The volatility of portfolio flows induced by global spillovers is the main source of exchange rate volatility in India.

- Foreign exchange interventions, both spot and forward, effectively counter capital flows volatility, with symmetric effects of purchases and sales.

- The impact of gross spot intervention on exchange rate volatility indicates the existence of threshold effects, explaining the role of the RBI in "leaning against the wind" phenomenon.

IV. A Suite of Approaches for Estimating Equilibrium Exchange Rates for India 2.0

By Michael Debabrata Patra, Harendra Behera, Dhirendra Gajbhiye, Sujata Kundu and Rajas Saroy

Equilibrium exchange rate models provide guiding frameworks for assessing the "fair value" of the exchange rate, based on economic fundamentals. This paper expands the suite of equilibrium exchange rates to cover the capital enhanced equilibrium exchange rate (CHEER), the desired equilibrium exchange rate (DEER) and the natural real exchange rate (NATREX) approaches. It offers a framework for understanding exchange rate dynamics focusing on the role of price differentials, interest rate differentials, social thrift, productivity and the current account balance.

Highlights:

- Equilibrium exchange rates imply consistency with a given set of fundamentals over the medium to long term while acknowledging inherent trade-offs.

- There is no consensus in the literature on the correct concept of equilibrium exchange rate.

- Each of the concepts discussed and estimated in this paper and its prequel correspond to a particular policy question.

- Empirical results indicate that the Real Effective Exchange Rate (REER) has moved broadly in line with its long run equilibrium level as determined by macroeconomic fundamentals.

- These estimates are sensitive to key parameters, modelling framework and the choices thereof. Any assessment of exchange rate misalignment must be informed by empirical analysis.

V. Geopolitical Risk and Trade and Capital Flows to India

By Shesadri Banerjee, Harendra Kumar Behera, Harshita Keshan, and Michael Debabrata Patra

In an era of intensifying global tensions, understanding the economic implications of geopolitical risk (GPR) is critical. This article examines the pervasive role played by geopolitical risk in shaping India's trade and financial dynamics.

Highlights:

- Using multivariate time series models, the study finds that a one-standard deviation shock to the geopolitical risk index (GPRI) for India causes a decline in the trade and capital flows to GDP ratio by 0.9 and 0.2 percentage points while a similar shock to the GPRI for the world contracts trade and capital flows by 1.0 and 0.3 percentage points, respectively, with a marked difference in the timing and duration of the contraction.

- Given the relative predominance of the trade channel over the financial channel, the findings underscore India's needs to tailor its policy response with a suite of strategic and targeted interventions to mitigate the GPR shocks.

VI. Financial Stocks and Flow of Funds of the Indian Economy 2022-23

By Suraj S, Ishu Thakur, Mousumi Priyadarshini and Abhishek Nehra

This article presents underlying trends in the financial stocks and flows (FSF) across the institutional sectors of the Indian economy during 2022-23 on a from-whom-to-whom (FWTW) basis. The analysis of financial flows provides insights into interconnections across sectors and real economic activities by tracking the sources and uses of funds amidst evolving macroeconomic trends. The non-consolidated statements for the period 2011-12 to 2022-23 are also being released with the article.

Highlights:

- The financial assets of the domestic sectors registered a growth of 9.8 per cent in 2022-23 as compared with 9.9 per cent in 2021-22, while liabilities increased by 10.4 per cent compared with 10.2 per cent in the previous year.

- The domestic economy remained as net borrower in 2022-23, majorly on account of moderation in the funding from household sector.

- Households and financial corporations remained as surplus sectors, accommodating the general government's and non-financial corporations' deficits.

- Financial assets and liabilities of other depository corporations experienced the highest growth since 2014-15 as credit demand from households and businesses remained buoyant.

- The increase in flows from other depository corporations to the general government reflects higher public borrowing requirements.

- Currency and deposits, loans and advances, and debt securities accounted for nearly two-thirds of the total financial assets and liabilities at end-March 2023.

VII. Fiscal-Inflation Nexus: Is there a Feedback Loop?

By Harshita Keshan, Garima Wahi and Krishna Mohan Kushwaha

In the context of the post-pandemic experience of prolonged elevated global inflation and the surge in government debt ratios, this article examines the fiscal-inflation nexus in a comprehensive framework of panel vector autoregression (PVAR).

Highlights:

- The study suggests that high inflation can temporarily deflate away debt burden, but this effect is neither permanent nor sufficient to address long-term fiscal challenges.

- The findings underscore the inflationary effects of high public debt, emphasising the necessity of fiscal consolidation.

The views expressed in the Bulletin articles are of the authors and do not represent the views of the Reserve Bank of India.

(Puneet Pancholy)
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