Monetary Policy | RBI chooses a gradual, non-disruptive approach

October 08, 2021

A few weeks ago, the Reserve Bank of India (RBI) Deputy Governor Michael D Patra said at an event that the RBI doesn't like tantrums. It likes tepid and transparent transitions, glide paths rather than crash landings. The October 8 monetary policy review is a testimony to that viewpoint.

RBI Governor Shaktikanta Das restated the same position, as he said the liquidity measures necessitated by the COVID-19 pandemic-induced crisis would need to evolve in sync with the macroeconomic developments. This process has to be gradual, calibrated, and non-disruptive, while remaining supportive of the economic recovery.

Based on its macroeconomic assessment, the Monetary Policy Committee (MPC) unanimously voted to maintain status quo on policy rates, and by a majority of five to one to retain the accommodative policy stance. In view of the existing liquidity overhang in the system, the RBI has not announced a new G-SAP (G-sec Acquisition Programme) calendar, but has assured that it would continue to flexibly conduct other liquidity management operations, including Operation Twist (OT) and regular Open Market Operations (OMOs).

While a few may interpret this move as the beginning of the liquidity normalisation process, the RBI officials have made it clear that the first step to normalisation is stopping addition to liquidity, which has not happened. To ensure a balance between liquidity conditions and the growth process, they have increased the tenor and quantum of the variable rate reverse repos so that the excess money doesn't go into overnight market every day.

Turning to the MPC's macroeconomic assessment, while a few high-frequency growth indicators gained momentum during Q2, 2021-22 (FY22), aggregate demand is still slack, and the overall output is still below pre-pandemic level. Economic recovery remains uneven, and dependent upon continued policy support.

On the contrary, the inflation scene has improved. Growth momentum in CPI inflation is moderating, which combined with favourable base effects in the coming months, could bring about a substantial softening in inflation in the near term.

Rising trends in global commodity (especially oil) prices and weather-related events do pose a risk to future inflation trajectory, but it was prudent that the MPC did not respond prematurely by raising policy rate (reverse repo rate), as overall growth is still fragile.

According to the governor, the RBI wants to bring inflation closer to the target in a gradual and non-disruptive manner. Interestingly, in his initial remarks, the governor did say that "while responding to the pandemic induced economic shock, the RBI has not been a prisoner of any rulebook". It will help if bond market participants understand this position sooner than later before creating undue nervousness in the market.

Factors such as spikes in crude oil price, US treasury yields, actions of major central banks may impact Indian bond yields temporarily, but they will not rise sustainably as long as the RBI remains on a resolute pause

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Another very important point made by the RBI governor is that diverging monetary policy stances are not being dictated by country groupings but by country circumstances. India today belongs to the group of those countries that are experiencing inflation in the elevated zone because of cost-push factors but are suffering from nascent economic recovery that needs nurturing. That is the reason why central banks of these countries (including India) are on a resolute pause.

According to the governor, the conduct of monetary policy in India will continue to be oriented to our domestic circumstances. It needs to be understood by the bond market players that we are not grappling with demand-pull inflation, and the blunt action of monetary tightening may not work when the growth is decidedly uneven. Hence, it was a prudent decision to maintain the accommodative stance while unwinding the exceptional liquidity support that was not supporting the growth process.

Against the backdrop of increased stresses in agriculture and rural belts (due to uneven monsoon rains) combined with the pandemic-induced disruption in the informal sector (both in the rural and urban areas), we do not see rate hikes or change in stance at least until the end of the calendar year. Looking forward, global factors such as spikes in crude oil price, US treasury yields and actions of major central banks may impact Indian bond yields temporarily, but they will not rise sustainably as long as the RBI remains on a resolute pause.

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