RBI must address increasing uncertainties in monetary policy

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The monetary policy committee (MPC) of the Reserve Bank of India (RBI) raised the repo rate by 25 basis points on 6 June in its last policy review, citing major risks to Consumer Price Index (CPI)-based inflation from crude prices, elevated inflation expectations, HRA provisions by states and increase in minimum support prices (MSPs) of major kharif crops.

The MPC, however, sounded more sanguine on growth because of improved capacity utilization and credit offtake, supported by healthy consumption demand.

Since the last policy meeting, the price of Indian basket of crude has not changed much. Currently, it is hovering near $71-72 per barrel. Results of RBI's latest inflation expectations survey are still not out, but we expect inflation expectations to stay elevated as CPI has surged by 42 bps and core CPI by 56 bps between April and June 2018. On the state government front, Maharashtra has already announced a pay hike for its employees from Diwali (November 2018) following the recommendations of the Pay Commission.

Given the economic chaos, it will be prudent for RBI to move with caution and raise rates gradually

Possibility of similar steps by other state governments has increased the probability of another bout of wage-push inflation during 2018-19. While higher MSPs need not translate into higher food inflation given the dynamics of procurement and demand-supply mix, an erratic and patchy rainfall this year certainly poses a risk to food inflation. Until 20 July, the area under kharif crops is down by 9.3% (y-o-y), due to rainfall deficiency in East India, Uttar Pradesh, Bihar and parts of Gujarat.

REUTERS

RBI will announce the monetary policy on 1 August.

Given the increased risks to inflation and heightened volatility in the rupee (which has further depreciated against the dollar by nearly 3% since 6 June), there is no alternative for the MPC but to increase the policy rate further by 25 bps on 1 August. This is because RBI is an inflation-targeting central bank, which is now committed to the medium-term inflation target of 4%.

COMMENTARY

However, in its policy statement, the MPC will have to highlight several uncertainties the RBI is currently facing and which have the potential to act as a harmful element for the effectiveness of monetary policy.

First of all, unlike at the time of the last policy review, activity indicators are no more projecting a robust growth picture.

Recent growth prints for core sector and industrial production have shown a significant deterioration on the back of a slowdown in infrastructure and construction goods and a negative growth in consumer non-durables. The Centre for Monitoring Indian Economy's capex database shows a continuous fall in value of new project announcements. Thus, there are question marks over the sustainability of the growth momentum witnessed earlier.

On the agricultural front, one-fourth of the nation has received deficient rainfall so far and hence, there is an uncertainty about the prospects of the farm sector and purchasing power. The International Monetary Fund, too, has recently cut India's growth projections by 10 bps for 2018 and by 30 bps for 2019, citing faster-than-anticipated monetary tightening and higher crude oil prices.

Other major uncertainties are related to crude prices, impact of increasing trade frictions on exports, outcome of upcoming state and national elections, huge pipeline of state development loans and the time required for unlocking the capital from the stressed assets loan-book of banks lending to corporates.

Given the chaos in economic environment and increased probability of unanticipated events, it will be prudent for RBI to move ahead with caution and raise the rates gradually, without hurting the "neutral" stance of monetary policy. Active domestic open market operations in close coordination with foreign currency market interventions alone will provide a conducive operating environment for the financial sector to support economic growth.

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