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# Time to Act for RBI!

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Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) in its bimonthly meeting on December 6 to 8 announced its policy interest rate. Focusing on growth, it decided to maintain the repurchase rate (Repo) at 4%, continuing to the borrowing cost cheaper since May 2020 for meeting the negative economic impact of Covid-19 pandemic. The primary goal of RBI is price stability with the target of 4% annual inflation with a plus or minus margin of 2%. The reverse Repo at which the RBI borrows money for draining surplus liquidity remains unchanged at 3.35%.

Though the new variant of Covid-19 virus, the Omicrone is of major concern experts have comforting words that a more rapid coverage of population with two doses of vaccine would reduce severity of any infection; and an additional booster shot for the elderly, the usual masks, social distancing and other precautions should be adequate. What is feared most is the impact of faster normalization of monetary policy in the advanced countries, with rise in interest rates, with impact on rest of the world economies, including India. In US, supply disruption and shortage issues and rise in rents and wages have pushed the inflation from 5.4% in June to 6.8% in November. In Euro-zone, Germany registered the highest inflation, at 6% in November since 1997, in both cases against the targeted rate of 2%.

Any delay by RBI to adjust to new external conditions would spell disaster in terms of outflow of capital in response to widening interest rate differential as well as loss of credibility in RBI's approach to price stability as primary objective. In today's world, macro-economic factors matters. The risk loving foreign institutional and portfolio investment funds seek higher returns with predictable stability. They tend to move in and out at the click of the mouse. Depreciation of the rupee renders essential imports, including petroleum crude more expensive.

RBI wanted the economy to be more prepared for the likely monetary tightening. Through measured steps of absorbing surplus liquidity by increasing the number of variable rate reverse repo auctions, RBI planned to drain Rs 9 lakh crore by end 2022, hoping eventually the overnight rate would begin to rise and be near close to Repo rate, amounting to normalization.

*Optimistic expectations*

The RBI's decision was based on the assumption that consumer price index (CPI) and wholesale price index (WPI) inflation, which were due to high retail prices of petrol and diesel, would fall in November following the cuts in central excise as well as in VAT by some states. Other assumptions were supply incentives and seasonal corrections in prices of winter vegetables and fruits would help.

November CPI and WPI inflation released on December 13 and 14, just after a week of MPC decision were a shock. The November CPI inflation was up, at 4.91% rising from 4.52% in October and 4.40% in September, though within the permissible margin. On the other hand, WPI inflation was in double digits at 14.23%. The MPC relied on a three-week old inflation data of Nov 13. Will RBI discontinue the practice of holding the bi-monthly MPC meeting in the first week of the month, but conduct it after 15th of the month?

*World-wide inflation: A new "pandemic*"?

Tobias Adrian and Gita Gopinath of IMF observed last week that in the context of supply-demand imbalances, continuing a monetary policy stance aimed at supporting recovery could fuel substantial and persistent inflationary pressures. Their advice is that in countries where economic recovery is under way with rising inflationary pressures, it would be necessary to accelerate the normalization of monetary policy.

The news is on hand that the US Fed Reserve is to chart a path of higher interest rates in the New Year, just a fortnight away. Its rate-setting committee would soon speed up the end of its bond-buying program for the lift off of interest rates from near zero held since March 2020, causing jitters to capital markets.

Last week, the rupee ended at an 18-month low at Rs. 75.78, as foreign institutional investors/foreign portfolio investors turned net sellers of equities worth Rs. 1,092 crore. This also added to the rupee's weakness as the dollar strengthened on expectations that the US Fed might hike interest rate. The hawkishness of the US Fed and the continuing dovishness of RBI would contribute to further weakening of the rupee. Increases in telecom rates, a hike in GST rate on clothing and footwear are all ready to push the CPI inflation around 6% in December.

Now, we have another bad news: it is the trade gap in November, $ 22.90 billion, the highest in two decades. Weak macroeconomic fundamentals erode confidence, leading to pulling out of capital, aggravating herd mentality. On Wednesday, the rupee weakened past Rs 76/US$.

On Thursday, December 17, Bank of England, the mother of all central banks, became the first to raise interest rate. It raised its Bank Rate to 0.25% from 0.1%. Governor Bailey observed that though Omicron was already hurting the economy, BoE is compelled to "stop the recent jump in prices from becoming a longer-term problem".RBI has to restore credibility. Price stability is the primary goal.

It is time to act now.

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