DH
DECCAN HERALD

Tuesday, October 10, 2023

Is Reserve Bank heading in the right direction?

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The monetary policy decision on Friday, October 6 by Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) has raised concerns. The key interest rate, known as the repurchase rate (REPO) at which banks and primary dealers borrow funds against collaterals of the government issued securities for short term loans has been kept unchanged at 6.50%, fixed in February 2023. This will continue until the next meeting of MPC in December, influencing aggregate demand and determining growth, besides price stability, including the domestic purchasing power and external value of the rupee.

The MPC meets six times a year, in the first week of April, June, August, October, December and February. The data on inflation of the previous month are available only in the second week of the month. For example, when MPC met on Oct 4-6, it had no data on September inflation and it had to base its decision on August inflation, which was 6.83%. The October MPC decision is based on a more than one month old August inflation figure, not of September. This practice should be discontinued. The MPC should meet only in the third week of the month.

After the decision, RBI Governor spoke on the inflationary potential stemming from the adverse food situation due to El Nino havoc and uneven rainfall across the country: negligible rise in area under food grains and decrease in area under pulses and lentils. He also recalled the 'tomato famine' and high prices of vegetables, pushing retail inflation to 7.44% in July and some marginal relief offered by fall in August inflation to 6.83%.

The governor referred to low core inflation which is less than the retail inflation. The retail inflation is consumer index based, including all final consumer goods, which are targeted. The core inflation excludes prices of volatile food and fuel items and is usually below 5%; and less than retail inflation (6.83%), He knows that niceties by definition do not matter to the common man. The governor told the nation that RBI's inflation target is 4%, though it allows a margin of 2%, either way, plus or minus, 2% minus; and not the range of 4%- to 6% .

Efficacy of inflation target as a tool

Last month witnessed the advanced countries calling off their more than a year-long anti-inflationary campaign. The US Federal Reserve raised the interest rate to 5.50%

in July 2023 by 525 basis points, bringing down the inflation from a high of 9.1% in March 2022 to 3.7% in August 2023. Immediately after increasing the interest the rate to 5.25%, BOE announced no more hikes. Inflation has fallen from 11.10% in October 2022. to 6.7% in August. The European Central Bank (ECB) increased its key rate to 4% and signalled the end of hikes, with inflation at 5.3% in August. In all the three cases, inflation was above the 2% target. All the three advanced countries wanted their economies to grow, as fears of recession have receded. The oil exporting countries soon took the hint. Crude oil prices spiked, with the Brent crude now ruling around above $90 /barrel.

The efficacy of inflation target as an instrument of anchoring inflation expectations is now under scrutiny. In the August 2023 Jackson Hole Symposium in Wyoming State organized by the Fed, the world central bankers discussed the changing environment. They noted rising trade barriers, and a transition from fossil fuels to renewable energy, which needed high investments in renewable energies and resulted in rising demand for raw materials, all of which all stepped up aggregate demand. The aging population and shrinking labour market have created supply shocks. The message is the "new environment" would give rise to much larger price shocks than ever before.

India's challenges

India's challenges, in the context of impending elections accompanied by huge campaign expenditures abound now. There are growing risks to consumption demand, rising global crude oil prices and the eventual pass-through of energy prices affecting all sectors. The widening spread between Indian and US sovereign bond yields and the resultant outflows of short-term capital in pursuit of higher short-term gains elsewhere weaken exchange rate. Foreign exchange (forex) reserves are falling. They fell by $3.8 billion to $586.9 billion for the week ended September 29. This is a larger decline compared to the decline by $2.3 billion to $590.702 billion in the previous week of September 22. The trend might continue in the event of higher inflation expectations with the dovish pause. The only way to protect the Indian rupee is maintenance of price stability. Assured stability through firmer anti-inflationary measures sends an effective message to overseas investors.

A small rise by 25 bps in RPO at this critical juncture would have been more appropriate for ensuring both domestic and external price stability and for raising the credibility of RBI in its efforts to firm up inflation expectations.

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