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Monetary Policy, a vindication, but not a time to rejoice

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When the soft spoken Urjit Patel took over as the Governor from Raghuram Rajan, his predecessor with rock star status in the world of finance, there were those who wondered if the fiercely independent Reserve Bank of India, will continue its impeccable track record in setting monetary policy.

Growth versus inflation

India has seen a perennial tussle between the growth lobby from industry seeking a low interest rate regime, whose stance is often echoed by the Finance Ministry, and the inflation hawks from the central bank who seek low and stable inflation through higher policy rates, often at the expense of growth. Many would recall the famous quip from the then Finance Minister P Chidambaram that the government will walk alone in promoting growth, when the pleas from the Ministry to RBI to cut interest rates were ignored by Governor Subba Rao.

Dr Raghuram Rajan at the helm of RBI

Under Rajan, the central bank continued its stellar track record on many fronts. His Asset Quality Reviews at banks brought out many a hidden skeleton into the open. Stressed loans which were being ever greened to postpone the non performing tag and consequent provisioning, were identified and provided for. Rajan made sure that neither the ministry nor the industry even remotely influenced monetary policy, with many of the policy rate announcements taking everyone by surprise.

A lasting legacy of Rajan was the Monetary Policy Framework Agreement signed between the Government and the RBI on 20th February 2015. The objective of the framework is to primarily maintain price stability, while keeping in mind the objective of growth. As per the agreement, a six member Monetary Policy Committee (MPC) would be entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level, as below.

Inflation Target: Four per cent.

- Upper tolerance level: Six per cent.

- Lower tolerance level: Two per cent.

Out of the six Members of MPC, three Members would be from the Reserve Bank of India (RBI), including the Governor, who will be the ex-officio Chairperson, the Deputy Governor, and one officer of RBI. The other three Members of MPC would be experts in the field of economics/banking/finance/ monetary policy. The meetings of the MPC would be held at least 4 times a year and it would publicise its decisions after each such meeting.

Dr Urjit Patel takes over

Right from his early days at the helm, the new Governor Urjit Patel, continued the tradition of the central bank's independence. In the December 2016 monetary policy review, status quo was maintained on rates while the market had taken a 25 bps cut for granted. The next review shocked the markets with a change in policy stance from accommodative to neutral.

The next Committee meeting in June 2017 would understandably have been a stormy one. It forecast consumer price inflation (CPI) of 2-3.5 % for the first half of 2017-18 and 3.5-4.5 % for the second half, much lower than the 4.5 % and 5 % respectively, projected in the previous meeting. There was tremendous clamour from the industry to cut rates to revive growth in the economy. But the Monetary Policy Committee stood its ground, stating that premature action risks disruptive policy reversals later and the loss of credibility. Accordingly, the MPC decided to keep the policy rate unchanged with a neutral stance and to remain watchful of incoming data. One member of the MPC dissented.

With the actual CPI reading for June plummeting to 1.54 % even lower than the revised forecasts, the MPC relented and reduced the policy repo rate by 0.25 pct. in the August 2017 meeting. The MPC stated that it will continue monitoring movements in inflation to ascertain if the recent soft readings were transient or if a more durable disinflation is underway.

Oil prices and inflation

Oil prices play an outsized role in the trajectory of inflation in India, with bulk of petroleum requirements being imported. Oil price impacts current account balance, fiscal deficit and the exchange rate of Rupee in the FX markets. International prices move based on a complex inter play of factors that include the classic demand supply equation, strength of the US Dollar in which it is denominated, geo political scenario in the Middle East which is a perennially volatile region, shale oil production in the US which is a recent development, etc. A very important factor is the ability of the oil cartel, the Organization of Petroleum Exporting Countries (OPEC) in reaching agreement among its members to control production and enforcement of the agreement.

WTI crude oil futures which fell to a low of USD 43 a barrel in the first half of 2017, have shot up to USD 57 dollars, an increase of 33 pct. One can do the math on the impact of this increase, with India's annual oil import bill of about USD 80 billion. Consumer price inflation, just beginning to factor this in, is already on the upswing at 3.28 pct. in September and 3.58 pct. in October 2017, up from 1.54% in June.

MPC's stance is vindicated

The defensive tone of the Monetary Policy Committee as observed from its previous policy statements, turned remarkably confident in its latest statement from the October 2017 meeting. Gone was the wariness to stick its neck out in stating that current deflationary trends were purely transient. The October Monetary Policy Report stated that the softness in headline inflation observed during April-June 2017 is expected to reverse in the coming months with CPI inflation projected to pick up from 3.4 per cent during August 2017 to 4.2 per cent in Q3:2017-18 and 4.6 per cent in Q4.

The erstwhile Governor Rajan called inflation a hidden tax on the poor and the middle class. No one would rejoice about the prescience of Urjit Patel and the Monetary Policy Committee on the inflation scenario. But in standing firm on the mandate to contain inflation by appropriate calibration of the policy rate, Dr Patel is vindicated and takes his rightful place in the pantheon of Governors of the august institution, the Reserve Bank of India.

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