RBI’s cautious stance likely to continue

Why in news?

The RBI’s Monetary Policy Committee raised the benchmark interest rate for a third straight meeting as policymakers battle to rein in inflation.

Why were the benchmark interest rates raised?

- The 50 basis points raise takes the policy repo rate to 5.4%, and, more significantly, to a level last seen in the pre-pandemic second quarter of fiscal 2019-20.
- This is when a growth slowdown and retail inflation of about 3.2% warranted a rate cut.
- The rate-setting panel had little option but to continue the withdrawal of monetary accommodation to prevent inflation.
- The prices of some of the industrial commodities and food items softened in recent weeks.
- The policymakers clearly opted to stay strongly vigilant at this juncture and erred on the side of caution, if needed.
- The RBI regards growth recovery based on a set of indicators, such as industrial capacity utilization, credit growth, government Capex and PMIs.
- The central bank kept its 2022-23 growth forecast of 7.2 percent unchanged.
- From an external sector and exchange rate perspective, globalized inflationary surges are prompting policy tightening in advanced economies.
- This is in turn roiling currency markets including appreciably weakening the rupee and adding imported inflation to the mix.
- Russia’s invasion of Ukraine and the resultant impact on trade flows from the conflict zone have upended supply chains for several commodities and added to price pressures for a range of goods.
- The latest geopolitical tensions were triggered in East Asia by U.S. House Speaker Nancy Pelosi’s visit to Taiwan in the face of Beijing’s dire warnings.
- And China’s decision to respond with aggressive military drills around one of the world’s busiest shipping lanes could also impact global trade.
- All these are at a time when uncertainty and risk aversion are already high.

Why have there been rapid hikes?

- Successive shocks to the global economy had led multilateral institutions including the IMF to lower their global growth projections and highlight the rising risks of a recession.

- With all the six members in favor of a 50 bps hike, the MPC has delivered a 140 bps hike in the repo rate in less than three months, by far the fastest pace of rate hikes in recent years.

- Meanwhile, the liquidity surplus in the banking system also continued to move lower.
- Interestingly, one of the MPC members did not support the monetary policy stance of "withdrawal of accommodation" and perhaps preferred a more cautious stance.
- The RBI announcement clearly prompted the fixed income markets to expect more rate hikes ahead.
- This leads to the 10-year benchmark bond yield to climb higher to around 7.30 percent, about 20 bps higher than the intra-day low observed prior to the MPC communication.
- Even if the current approach means a somewhat slower recovery immediately, the central bank stays focused on financial stability and long-term sustainability of growth.
- In the context of deciding on the terminal policy rate, a factor will likely be the share of assets books of the banking system that reflects external benchmark linked rates (EBLRs).
- At over 40 percent now as against a tiny single-digit number in the previous hiking cycles, which is witnessing nearly instantaneous and complete pass-through of the central bank's rate signals.

What is the deficit problem?

- The unusually large trade deficit in recent months, FII outflows during the summer, and potentially a sizeable deficit on both current and capital accounts have led to this move of the RBI.
- The rupee also touched the psychological mark of 80 against the dollar recently, one sees this as a result of generalized dollar strengthening despite the rupee outperforming a large number of other currencies.
- Also, India's trade gap will likely narrow in H2 of 2022-23.
- Furthermore, the RBI is not only using a part of its sizeable forex portfolio to support the rupee, several other policy initiatives on the part of both the RBI and the government.
- For example measured trade restrictions, rupee settlement in external trade, and greater flexibility for banks as regards non-resident deposits.
- All these should help materially in the coming months in containing rupee weakness.
- This would help anchor price gain expectations firmly and surely enhance the RBI's inflation-fighting credentials.

What is the way forward?

- Disquietingly, globalization of inflation is coinciding with deglobalization of trade.
- The MPC has clearly chosen to stay cautious, a broad stance that will likely continue in the late September MPC meeting also.
- However, incoming data on the evolving growth-inflation dynamics both at home and abroad, and external sector situations will play a key role in determining the MPC's bias subsequently.
- Barring further unforeseen surprises, a relatively less challenging backdrop as regards these parameters may allow the MPC to keep the repo rate unchanged during H2 FY23.

Reference:

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