

More on inflationary pressures

■ Dr. T. K. Jayaraman



Minutes of the meeting of the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) held on August 4-6 were released on 20, creating some concerns rather than strengthening confidence. A lone and dissenting statement which was attached to the minutes was by Professor Jayant Verma, although the final decision was unanimous to maintain the same low benchmark at 4% which acts as the 'lighthouse rate' for all other rates of interest.

The third bi-monthly MPC meeting of FY 22 announced maintaining the status quo for the seventh time in a row, keeping the key the repo rate at which the RBI lends money against the collateral of government bonds to commercial banks for the repurchase obligation at 4%. The reverse repo rate - the rate at which the RBI borrows money from banks - was kept at the rate of 3.35%.

The RBI retained the Gross Domestic Product (GDP) growth projection for the current fiscal at 9.5%. Given inflationary concerns, it increased the CPI inflation forecast to 5.7% from 5.1%.

While the RBI Governor wanted to continue the monetary policy support at 4%, no doubt he stressed the need for watching durable inflationary pressures and sustained price momentum so as to as to bring back the CPI inflation to 4% over a period of time in a non-disruptive manner. The Deputy Governor added that the highest priority was the revival of growth.

The lone dissenting view

Professor Jayant Verma recalled that although the past decision, which was based on the waiving of risk and reward, was in favour of monetary accommodation, things do not appear to remain the same. They are changing. As the pandemic continues to mutate, Dr. Verma felt that the balance of risk and reward was also gradually shifting, which deserved a hard look at the accommodative stance.

Referring to the Covid-19 pandemic, Professor Verma opined that the ability of monetary policy to mitigate a human tragedy of this nature is very limited as compared to its ability to contain an economic crisis. Referring to global experience,

in particular, to Israel which was witnessing rise in Covid-19 positive case counts, despite very high levels of vaccination, he stated that indications are clear that vaccination is insufficient to stamp out the pandemic though it might reduce its severity. According to Professor Verma, the possibility that Covid-19 will haunt us (though with lower mortality) for the next three to five years can no longer be ruled out and keeping monetary policy highly accommodative for such a long horizon is very different from doing so for what was earlier expected to be a relatively short crisis.

In the early phase of the pandemic which caused generalized economic distress, easy money policy was appropriate. Further, only a few narrow pockets of the economy were affected. At industry level, contact intensive services suffered heavily, while many other industries are now operating above pre-Covid levels. At the firm level, MSMEs have suffered severely, while large businesses have prospered. At the household level, the pandemic has been devastating for weaker sections of the society, while the affluent have weathered it reasonably well. Geographically, the pandemic has done its worst damage in around 100-200 districts spread across a relatively small number of states.

Professor Verma rightly stressed the limits of monetary policy and stated that it is much less effective than fiscal policy for providing targeted relief to the poor and the worst affected segments of the economy. For the rich, cheap monetary policy results in boosting asset price inflation to a greater extent than it is mitigating the distress in the economy.

The Upper limit is not the target

Referring to inflation, there are indications that inflationary expectations are becoming more widely entrenched. After averaging above 6% in 2020-21, inflation is forecast to be well above 5% in 2021-22, and is not expected to drop below 5% even in the first quarter of 2022-23 according to RBI projections. Professor Verma reminded MPC that the target before RBI is 4%, not 6%, and not even 5%. The rate 6%, which is derived from the allowable band, plus or minus 2% is the upper tolerance band of 6%. The upper brand is to permit forecast errors, and measurement issues.

Professor Verma in conclusion observed that the current level of the reverse repo rate at 3.35% is no longer appropriate. In the context of the forecasted high inflation above 5%, monetary accommodation has to be restrained, and, therefore, he argued for raising money market rates towards the repo rate of 4% from the current ultra-low level of 3.35%. The repo rate of 4% corresponds to a negative real rate in the range of 1-1.5% based on forward looking inflation forecasts, which was currently appropriate for reviving economic growth without excessive risk of an inflationary spiral.

Dark clouds on the horizon?

Will the Taliban takeover of Afghanistan impact global crude oil prices? It is not a major consumer country nor a crude producer country. With America trying to hunt down the culprits behind the attack on Kabul airport, India TV News reports uncertainties would spread over the region such as Saudi Arabia and UAE which are major oil producers in the world. Saudi Arabia is the second-largest oil producer in the world, exporting about 59% of its crude.

India TV News quoted energy expert Narendra Taneja who stated things would worsen if the Taliban go back to their old ways and allow sanctuaries to Islamic fundamentalists from

hydrocarbon-rich Middle East, North Africa, and Central Asia. He added, “If they change, they will not be Taliban.”

Barrons, a Dow Jones said that tensions in the “Middle East have the potential to lift prices.” It noted that earlier JP Morgan had predicted that oil prices could touch \$80 a barrel with rising demand and constrained supply. ■



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