



# The Dilemma before RBI: price stability or growth

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Early last month, the Reserve Bank of India (RBI) announced its monetary policy decision at the end of the bi-monthly meeting of the six-member Monetary Policy Committee (MPC). The expectations were that RBI would be focused on boosting growth with a downward revision in its benchmark policy interest rate - which is benchmark repurchase rate.

It did not happen.

It might have also disappointed a few who were advocating an expansionary monetary policy including printing money, led by a former finance minister.

Viewed against the strengthening of dark clouds of inflation in the wake of rising crude oil prices, the MPC decision was to continue the repo rate - RBI's key lending rate - unchanged at 4% and the reverse repo rate - the borrowing rate for banks on their loans from RBI - at 3.35%, keeping their options open, although there is no change in pro-growth stance. So far, RBI has cut the benchmark repo rate by a total of 115 basis points (bps) since March 2020.

### Primary objective

The primary objective of the RBI monetary policy since 2014

has been price stability. In February 2015, the government and the central bank agreed on targeting an inflation target of 4%, with a band of plus or minus 2 percentage points, which is followed since 2017.

The RBI's latest approach appears to be in that direction. Though there has been some momentum of growth, which was evident in the second half of 2021, the coast is still not clear. There have been shortages of vaccine since late May and early June. Further, the second wave from late March was wrecking the economy with growing rates of infection and deaths. The RBI took the view that the best policy is to wait and not to hurry with another cut but to "nurture the recovery after it has taken root."

Although the Indian economy recovered after the first two quarters of contraction in FY 21 and grew at the annualized rate of 1.6% in the last quarter (Jan-March 2021), the full FY 2021 GDP contraction was 7.3%. The RBI also revised the estimated growth rate for the whole FY 2022 at 9.5% downwards, although earlier, the government's Chief Economic Adviser predicted that the second wave of Covid-19 with its new variants would not have a much impact on India's recovery. RBI had a dimmer view.

The projected quarterly estimates for FY 22 are: 18.5% in Q1; 7.9% in Q2; 7.2% in Q3; and 6.6% in Q4. On the price front, the CPI inflation projections are: 5.2% in Q1; 5.4% in Q2; 4.7% in Q3; and 5.3% in Q4 (Table 1).

Now with the reported arrival of the highly transmissible Delta plus variant (Times of India June 26), it looks that the lockdown relaxations may be reinforced in many major states, including Maharashtra and Tamil Nadu. The growth prospects are not that bright any more. Furthermore, revisions have to be made soon with new developments on internationally traded commodities prices front, which include the price of India's lifeline, the petroleum crude.

### Inflation fears

With the mounting oil prices (Table 2) on a-month to month-basis since January 2021, the wholesale price index (WPI) has been rising; and the month-to-month WPI inflation is shooting up. The CPI inflation is based on core items, excluding the volatile items of food and fuel. However, rise in oil price, which is reflected in petrol and diesel prices used in transportation of manufactured goods as well agricultural produce including daily supply of vegetables and fruits across the states, would be duly reflected in the prices of all consumer goods. The lag in time would be minimal: one month. So, CPI and WPI would move together, displaying a high degree of correlation. Viewed against this background, in retrospect, the MPC decision of June 4 to maintain the key lending rate at 4% seems appropriate.

### Increasing money supply

The "extreme" remedy, printing money, is now out of place. The argument in favour of increasing money supply runs like this: rise in money supply would lead to fall in interest for inducing growth in credit, as excess deposits with the banks earning no income or the opportunity cost of holding such excess money is high, banks will have to lend it out and acquire interest earning assets as loans. Credit growth has, however, been sluggish in recent months. A declining economy holds no attractive prospects for the private sector.

In fact, money supply is on the rise. That is due to high and bulging deficits, both of the central (6.8%) and state governments (4%), totaling 10.8% of GDP. If the deficit of another 1% due to fighting the pandemic with free vaccination for all and other related expenditures is added, the central budget deficit would rise to 7.8% of GDP. If the government borrows from banks and the public, the money is created, as the proceeds are electronically deposited in their accounts. More money is put in the domestic economy. Given the supply of goods and services, demand created by additional money drives up the prices. Prof Rangarajan, a former RBI Governor made it clear that monetary expansion is already happening. In fact, RBI has planned to buy ₹1.2 trillion worth of bonds in the September quarter on top of its current quantitative easing programme called G-SAP 1.0.

If the government prefers, it can sell bonds to a willing central bank (of course, the latter can assert its independence by saying "No to fiscal abuse!") which does not have to print money. By electronic transfer, financial resources to the central government are stepped up. This process is known as direct monetization of the deficit, a route which President Mugabe of Zimbabwe exploited each year.

Another former RBI Governor Subbarao warned direct monetization should be absolutely the last resort in an emerging economy such as India with weak institutional structures. It will "dent our policy credibility, which would have long term implications."

In the short-term price stability will be adversely impaired, as oil price is soaring. The central government and the state governments have to take a fiscal policy decision to reduce the GST and other levies. Of course, that would imply a rise in budget deficits.

### The dilemma

It appears that oil price will continue to rise. It was \$ 66 per barrel in May 2021, having risen from \$ 49 per barrel in December 2020. The latest oil price as of June 26, 2021 is around \$ 75 per barrel for all three: WTI, Brent and Dubai Fateh.

INDIA: Quarterly GDP Growth Rates and Inflation (2020-21 Actual) and Projections for 2021- 22								
	FY 2020-21 Actual				FY 2021-22 Projected			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>Real GDP</b>								
Real GDP Growth Rate (Percent)	0.4	-25.9	23.7	7.9	18.5	7.9	7.2	6.6
<b>Inflation</b>								
CPI (year to year in percent)	6.23	7.27	4.59	5.52	5.2	5.4	4.7	5.3
WPI (year to year in percent)	-1.81	1.32	4.17	7.89	6.8	12.95	NA	NA

Sources: SBI EcoWrap and Trading Economics

Month to Month Inflation from December 2020 to May 2021						
Inflation	2020 Dec	2021 Jan	2021 Feb	2021 March	2021 April	2021 May
CPI (year to year in percent)	4.59	4.06	5.03	5.52	4.23	6.31
WPI (year to year in percent)	1.95	2	4.2	7.89	10.49	12.95
WPI Fuel (year to year in percent)	-8.7	4.8	0.3	8.9	20.9	37.6
<b>Oil price per barrel</b>						
Crude Dubai Fateh (US\$/barrel)	49.26	54.16	60.57	63.95	62.97	65.98
Crude Brent (US\$/ barrel)	48.73	53.7	60.46	63.87	62.95	66.4
Crude Western Texas Intermediate (US\$/barrel)	47.05	52.1	59.07	62.35	61.71	65.18

Sources: SBI EcoWrap and Trading Economics

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News of recovery in growth and increased coverage of population with vaccination in advanced countries as well as in emerging nations, especially in India, which is one of the three world's largest importers of crude appear to be the chief reasons for upward pressure on oil and other international commodity prices. As CPI inflation, the target rate for RBI rose to 6.30% on yearly basis in May '21, as compared to 4.23% in April 21. The SBI study has revised the inflation forecast for FY 2022 to 6.1% - reporting the core inflation (Y-Y basis) - which does not include volatile items would touch 6.4% soon, which is plus two standard deviations above the upper limit of the RBI target of 6%.

The bank also kept the reverse repo rate, the borrowing rate, unchanged at 3.35%. Meantime, officials project GDP growth at 9.5% in the fiscal year 2021/22, down from a previous forecast of 10.5% consisting of 18.5% in Q1; 7.9% in Q2; 7.2% in Q3; and 6.6% in Q4. On the price front, CPI inflation is projected at 5.1% during 2021/22: 5.2% in Q1; 5.4% in Q2; 4.7% in Q3; and 5.3% in Q4. It decided to retain an accommodative policy stance 'as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy,' signaling there is still room to cut rates further. RBI expanded its version of

quantitative easing to keep borrowing costs anchored. It will buy an additional ₹1.2 lakh crore of bonds under the Government Securities Acquisition Programme (G-SAP) 2.0 in the second quarter.

In April, RBI committed to buying ₹1 lakh crore worth of government bonds from the market between April and May under G-SAP 1.0. Under G-SAP 1.0, RBI would have purchased government securities worth ₹40,000 crore on June 17. The move is aimed at supporting the government's borrowing plan at comfortable interest rates for financing budget deficits.

All these ideas will have to be re-assessed, in the light of the mandated price stability goal of RBI. ■

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