EXPLAINED ECONOMICS

Reading RBI's policy review

The reason the RBI has stuck to the hawkish stance could lie in its outlook for India's economic growth and inflation in 2023-24. The central bank expects the GDP to grow by 6.4%, but the growth rate to slow in every successive quarter through the year; and for retail inflation to not fall below 5% in any quarter

UDIT MISRA
NEW DELHI, FEBRUARY 8

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) on Wednesday raised interest rates further in an attempt to bring inflation back to the target level of 4%.

Monetary policy essentially deals with the supply and cost (interest rates) of money in an economy. The RBI's MPC meets every two months to assess the state of monetary activities, and may tweak the repo rate — the interest rate at which the RBI lends to commercial banks — in a manner that reduces price fluctuations in the economy while keeping the inflation rate (the rate at which the general price level in the economy grows) at a reasonable level.

As a general rule, when RBI is more concerned about containing inflation it raises interest rates (thus depressing economic activity), and when it wants to stimulate growth it brings down interest rates.

A significant review

The latest monetary policy review was significant for a variety of reasons.

One, it came just after the presentation of the Union Budget, which is the most important fiscal policy document of the year.

Two, it came at a time when Indian markets are roiled by uncertainty in the wake of the Hindenburg Research allegations against the Adani Group and the resultant upheaval in Adani stock prices.

Three, central banks around the world are currently either slowing down the pace of interest rate increases, or even considering halting monetary tightening.

Lastly, this was the last review of the current financial year (2022-23) and as such provided a good opportunity to understand how the RBI saw the Indian economy panning out in the next financial year (2023-24) the Budget for which has just been presented.

RBI's announcement

There are two aspects to any monetary policy: the decision on repo rate, and the

CHART 1

RBI FORECAST FOR 2023-24

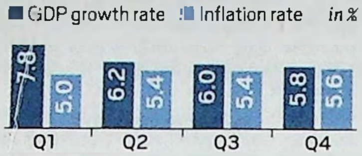


CHART 3

GDP GROWTH RATE

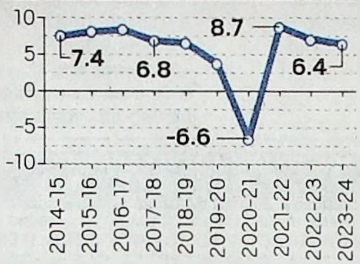
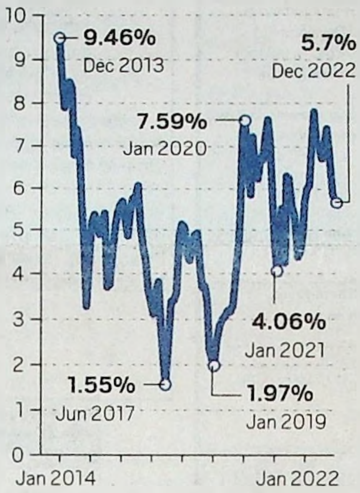


CHART 2

INFLATION RATE (IN %)



Source

"stance" of the policy. While changes to the repo rate affect the broader economy in terms of whether loans — for homes, cars, or factories — will be costlier or cheaper, the policy stance opens a window into how members of the MPC see the inflation and economic growth situation.

Since retail inflation has been outside RBI's comfort zone of 2% to 6% for 10 of the past 12 months, the stance has been focussed on "withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth".

On the repo rate, the RBI announced a 25 basis point increase, smaller than recent hikes (50 and 35 bps), which signalled the MPC's view that inflation has moderated faster than anticipated. It also signalled that India is possibly close to the end of the current cycle of interest rate hikes that began in May last year after retail inflation hit an 8-year high of almost 8% in April 2022.

"Consumer price inflation in India moved below the upper tolerance level (read 6%) during November-December 2022, driven by a strong decline in prices of vegetables," RBI Governor Shaktikanta Das said.

MPC not unanimous on hike

The decision to increase the repo rate was made by a 4-2 majority in the six-member MPC; government-nominated members Ashima Goyal and Jayanth Varma voted against the hike.

There was, indeed, a view that the RBI should refrain from raising rates because inflation is slowing faster than expected. Many had argued that the RBI should wait to understand how earlier rate hikes had affected the economy, and leave some space for economic growth.

On stance, too, there were expectations that the RBI would move to a "neutral" stance — suggesting that it no longer wants to expressly raise interest rates and would like to wait and watch how the situation unfolds.

However, here again the MPC decided in favour of maintaining the *status quo*.

Simply put, the RBI came across as more "hawkish" (read more concerned about high inflation than about the moderation in economic growth) than many expected.

Why hawkish stance

The answer may lie in the RBI's outlook for India's economic growth and inflation in the coming financial year. RBI expects that India's gross domestic product (GDP) will grow by 6.4% in FY24 — however, the growth rate will slow down in each quarter through the year.

"...Real GDP growth for 2023-24 is projected at 6.4 per cent with Q1 at 7.8 per cent; Q2 at 6.2 per cent; Q3 at 6.0 per cent; and Q4 at 5.8 per cent," the MPC's policy statement said.

At 6.4%, India's growth rate would slow marginally from the 7% it is expected to achieve in the current financial year and the 8.7% that it achieved in the previous financial year. But most economists who expected the RBI to pause interest rate hikes are of the view that GDP growth will barely cross 6%, if at all.

While for RBI, India's GDP growth remains sufficiently robust to not become priority number one, its outlook on inflation is higher than the expectation on the street.

The RBI expects retail inflation to be 5.3% through 2023-24 — and to not fall below 5% in any of the four quarters.

"On the assumption of a normal monsoon, CPI inflation is projected at 5.3 per cent for 2023-24, with Q1 at 5.0 per cent, Q2 at 5.4 per cent, Q3 at 5.4 per cent and Q4 at 5.6 per cent," the MPC said.

A specific worry for RBI continues to be the core inflation rate (or the rate of inflation when prices of food and fuel are taken out of the calculation). Core inflation is hovering around 6%, and signifies that high food and fuel prices have now seeped into the broader economy.

Bringing down high core inflation typically takes more time than controlling headline inflation because food and fuel prices often come down just as sharply as they go up.