# RBI monetary policy: A fine balance between growth and inflation

Anticipating an upswing in inflation, led by oil prices, the Reserve Bank of India (RBI) changed its monetary policy stance from accommodative to neutral in February 2017. Given the uptick seen in inflation, it was a prudent decision. A bigger challenge for RBI will be navigating through the next financial year. Higher yields, inflation and election cycle in the US and India are likely to lead to an increase in financial volatility in global and Indian asset markets and make RBI's task increasingly difficult.

While there are challenges, India's growth outlook is looking better than ever. The government's move to recapitalize public sector banks (PSBs) will ensue that credit is available for productive activities, in particular to micro, small and medium enterprises.

The capital allocation has also been thought through as banks under RBI's prompt corrective action have been given higher allocation so as to ensure that they will be in a position to lend and grow. Moreover, government's planned spending on roads, affordable housing and railways along with pick-up in exports will ensure that economic growth improves to 7.5% in 2018-19 from 6.5% in 2017-18. Will this growth be inflationary? This will be the biggest factor deciding RBI's rate trajectory. As of now, the industrial sector is sitting on excess capacity. Even as growth outlook is improving, the private sector is still not looking at expanding capacity. According to CMIE data, capital formation in the country has increased only by higher government orders which now form 55% of outstanding order book compared to 45%, a few years ago. Investment in real estate is also weak as households are increasingly investing in financial assets such as mutual funds instead of housing. As a result, even as the gap between potential and actual output narrows, there may not be a generalized pressure on inflation.



Inflation data for now corroborates this. The recent increase in inflation is driven by vegetables and housing. If we exclude the above two (including pulses which is deflating the index), CPI inflation has averaged 4.2% during April-December 2017 compared with 4.9% in FY17 and 4.5% in FY16. This has been achieved despite oil prices doubling in the last two years. In addition, global food prices have not yet seen a pass-through of higher energy prices. However, pressure on food inflation may increase. The government reiterated its stand on doubling farm incomes by 2022 in the Union budget. For the same, the government is looking at ensuring that farmers are remunerated adequately. Food subsidy to Food Corp. of India has been increased by Rs36,000 crore in the budget.

Higher oil prices will not only add to inflation but also put pressure on government's fiscal arithmetic and consumption. The decline in the last few days if sustains will be helpful. Higher oil prices imply that households will allocate larger share of wallet to cooking and transport fuels thus substituting demand for other goods. Lower consumption also implies lower indirect tax collections. The government may look at reducing taxes on transport fuels to cushion the impact on retail prices which implies risk of fiscal slippage (as seen in FY18).

In addition, India's trade deficit as well as current account deficit will also expand. Oil imports have already increased to $76 billion in the first nine months of this financial year compared with $61 billion in the same period last year.

Monthly oil imports are now at $10 billion a month ($7.5 billion in FY17). India's current account deficit is likely to expand to 2.2% of GDP in 2017-18 from 0.7% in 2016-17. Even with a rising trade deficit, the rupee has been appreciating on the back of weaker US currency. A global risk-off may change the trend.

The balance of risks points to higher rather than lower inflation. Rising bond yields are also pointing to a pick-up in growth and inflation. The bond market is anticipating RBI to tighten monetary policy sooner than later. However, given that India continues to maintain positive real rates, RBI need not move in a hurry and has enough room to wait. Even as we see RBI holding rates on Wednesday, MPC members will sound extremely cautious and chart out the risks on the inflation front. A sharper-than-expected rise in international oil prices may change the thesis. Otherwise, we foresee a pause by RBI in 2018.

*Sameer Narang is chief economist at Bank of Baroda.*

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