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MAKING THE CUT

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

The RBI's monetary policy review on Thursday was framed in the shadow of the interim budget, and fiscal slippages, with the fiscal deficit now projected to be a little higher at 3.4 per cent against the budgeted target of 3.3 per cent for FY-19. It was also the first policy review of the new RBI Governor, Shaktikanta Das. In the event, the RBI surprised the financial markets and many analysts by announcing a 25 basis points cut in its key policy rate, the repo rate, from 6.5 per cent to 6.25 per cent, with two members of the Monetary Policy Committee, including the deputy governor in charge of monetary policy, Viral Acharya, voting for keeping rates unchanged. Indeed, the rate setting committee was unanimous on shifting the policy stance of the Indian central bank from calibrated tightening to neutral, saying that it would provide the flexibility to meet evolving challenges on the growth front.

The RBI has justified a rate cut, taking into account the food deflation, decline in headline inflation which is now projected to be below the mandated target of 4 per cent by the third quarter of the next fiscal, low oil prices and other external risks such as the impact of a slowing global economy, Brexit, trade wars and the prospect of fiscal slippages. The 130 basis points drop in inflation expectations for the upcoming fiscal in the December round of the household expectations survey of the central bank may have also influenced the rate setting committee. At 5.6 per cent, core inflation is still high. The question is also whether food deflation is sustainable and whether it would take a turn, which could then make it difficult for the RBI to reverse its stance. In its defence, the Indian central bank may also have been guided by the evolving stance of other global central banks including the US Federal Reserve and the European Central Bank, which appear inclined to keep monetary policy loose in the face of slowing growth.

The decision to cut rates, however, carries the risk of being perceived as a monetary stimulus after a relatively expansionist fiscal policy in the run-up to the national polls. If the reduction in policy rates is to be accompanied by an interim dividend or transfer of surplus to the government before the end of the current fiscal, it is bound to be seen as a compromise on the RBI's autonomy. It would be unfortunate if such a perception were to gain ground. For, it will negate the Indian central bank's hard fought gains on operational independence, especially since the Modi government formalised a monetary policy framework agreement which laid the foundation for it.

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