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BABY STEPS WON'T TAKE RBI FAR IF INFLATION MONSTER REAPPEARS

Relevant for: Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

India’s central bank is getting ready to unwind the unprecedented measures it has taken since last year to limit the damage to the economy from the coronavirus pandemic. The question now is whether the Reserve Bank of India (RBI) is correct in adopting the baby steps approach yet again.

Recall that the RBI had adopted a similar baby steps approach a decade ago while withdrawing the measures it took to offset the impact of the 2008 financial crisis. In hindsight, the then governor, D. Subbarao, had later said that the central bank perhaps should have hastened a bit. Governor Shaktikanta Das has a trickier situation than his predecessor.

On Friday, the central bank announced that it is ending its G-Sec Acquisition Programme (G-SAP) through which it infused close to 2 trillion worth of durable liquidity in the first six months of FY22. Step one of stopping liquidity injection has been taken. Economists believe that this would be followed by a reverse repo rate hike in the December meeting of the monetary policy committee (MPC) and finally a hike in the repo rate can be expected only in FY23.

“The steps on the G-SAP and VRRRs should push effective rates up sustainably and will likely be followed by reverse repo rate hikes (from 3.35% to 3.75%) over the December and February meetings. This, we think, will then be followed by a change in the stance from accommodative to neutral around the February/April meeting. Repo rate hikes will only follow in 2HFY22, in our view," wrote those from HSBC Securities and Capital Markets (India) Pvt. Ltd in a note.

In short, RBI would take more than a year to completely unwind its accommodative monetary policy. Some economists warn that this timeline could stretch further. While avoiding fresh injection of liquidity is easy, neutralizing the humongous surplus liquidity would be the biggest challenge.

Soumya Kanti Ghosh, chief economist at State Bank of India, points out that the central bank’s unwinding of $23 billion of forward dollars has resulted in liquidity injection. Further, the current surplus is an unprecedented 9-10 trillion.

“Given all this, the RBI’s attempt to bring down the reverse repo to 3-4 lakh crore in December as the governor has stated from the current 8.8 lakh crore will be the most challenging," Ghosh said in a report.

Fortnightly variable reverse repo rate (VRRR) auctions are tactical absorption tools and not permanent neutralizing ones. Ghosh expects that the Reserve Bank of India won’t be able to hike the reverse repo rate in December.

To be fair, RBI has made a strong case for a gradual approach in unwinding. It believes that the growth recovery is still fragile and there is enough slack in the economy. Demand is yet to reach pre-pandemic levels and capacity utilization remains far below the historic trend. Credit growth is still tepid. Risks to global growth too have emerged and could rub off on the domestic economy. A faster unwinding may cause disruptions in the financial market and may impact fund flow to productive sectors. Economists too see merit in a gradual withdrawal given the financial market disruption. But one cannot make an omelette without breaking an egg. The economic recovery

will lead to an increase in inflation. RBI is betting that inflationary pressures, both from supply side and from the recovery, do not get out of hand.

Can RBI go wrong in this assessment?

There are potential risks to RBI's assumptions here. Asset price inflation is already becoming stark, as bond yields surge worldwide and equity valuations back home seem frothy. Global commodity prices are not expected to ease as supply bottlenecks could take time to get sorted.

But perhaps a strong warning on prices can be seen in RBI's own surveys. Its consumer confidence survey shows that more Indians expect inflation to rise faster over the next one year.

True, household inflation expectations for three-month ahead and one-year ahead are lower in the current round compared with the previous one. That said, these expectations are still elevated.

Inflationary pressures may be transitory but if inflation expectations are not, the RBI will face a fresh problem.

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