

Diminishing options

The RBI has little room to use interest rates for achieving policy outcomes

The RBI's latest policy statement underscores the diminishing options available to it to address the economic fallout from the COVID-19 pandemic. The bank's Monetary Policy Committee left benchmark interest rates unchanged for a sixth straight meeting and reiterated that it would keep its policy stance accommodative 'as long as necessary to revive and sustain growth on a durable basis'. Since its May 2020 decision to cut interest rates by 40 basis points, taking the cumulative reduction in borrowing costs in the wake of the pandemic's onset to 115 basis points, the MPC has found itself in a bind. While the first lockdown constricted supply and demand for much of Q1 of the last fiscal, pushing the economy into a record 24.4% contraction during April-June and causing full-year GDP to shrink 7.3%, the second wave has crushed all-round demand and consumer confidence. The RBI's May round of the consumer confidence survey shows the Current Situation Index at a new all-time low, with 75% of households perceiving the economic and employment situations as having worsened further, and the future expectations index reflecting overall pessimism. It is hard to see the mere availability of low-cost credit helping revive the all-important consumption demand.

The MPC acknowledged the bleak outlook when it slashed its projection for Q1 growth by as much as 770 basis points to 18.5%, from the 26.2% it had forecast just on April 7. Banking more on optimism than hard data, the panel bumped up its growth estimates for the second half resulting in an overall cut of only one percentage point to its full-year growth forecast at 9.5%. For this, it has assumed rural demand will remain buoyant on the back of an expected normal monsoon, while noting that widespread infections in rural areas, which likely led to a sequential decline in tractor and two-wheeler sales in April, could undermine future demand. The other factor the RBI is banking on to provide a fillip to economic activity is an accelerated pace of vaccinations, over which it has virtually no control. To be fair, Governor Shaktikanta Das has used the bank's liquidity spigot as a tool to address some of the economic distress. A series of measures focus on bolstering credit flow to the hardest hit MSME and contact-intensive industrial and services sectors, respectively. Still, the MPC can ill-afford to drop the ball on its primary remit – ensuring inflation remains anchored. With international commodity prices, including crude oil, on an upward trajectory and no signs of domestic policy support to check skyrocketing petrol and diesel pump prices, inflation is sure to accelerate, posing a major conundrum to the RBI. Raising rates could risk hurting recovery, and not doing so could heighten inflation.