Tightrope walk

The RBI should not undermine its own credibility by delaying steps to rein in inflation

Governor Shaktikanta Das's statement accompanying the RBI's latest policy announcement highlights the bind that monetary authorities find themselves in. While the central bank's growth supportive actions – maintaining the benchmark interest rate at a decade low, ensuring ample liquidity and an accommodative policy stance – are yet to help engender a meaningful recovery, inflation continues to disquietingly hover around the 6% upper bound of its mandated target. Governor Das acknowledged the RBI's predicament when he said: "Before the onset of the pandemic, headline inflation and inflationary expectations were well anchored at 4%, the gains from which need to be consolidated and preserved. Stability in inflation rate fosters credibility of the monetary policy framework and augurs well for anchoring inflation expectations. This, in turn, reduces uncertainty for investors... increases external competitiveness and, thus, is growth-promoting." It is this vital inflation targeting remit that the Monetary Policy Committee has temporarily set aside in the wake of COVID-19 and its brutal impact, while the central bank focuses its efforts on using all available policy tools to simultaneously preserve financial stability and support a durable economic revival. Still, the central bank's outlook for growth and inflation shows it is cognisant of the ground realities and the limits to its policy options.

Asserting that domestic economic activity has started to recover with the 'ebbing of the second wave', the MPC is hopeful of a bounce back in rural demand on the back of agricultural output remaining resilient, coupled with urban consumption recovering as the manufacturing and service sectors rebound with a lag, and as increased vaccinations help release pent-up demand. However, given that underlying conditions are still weak and the Current Situation Index of consumer confidence in its own July survey is still stuck near the all-time low polled in May, the RBI has retained its full-year GDP growth forecast at 9.5%. The fact that it has at the same time lowered the Q2, Q3 and Q4 growth projections it made just two months ago, by between 0.5 and 0.9 percentage points, belies the uncertainty in its outlook. With the monsoon rainfall deficit once again widening to minus 4% as on August 8, latest *kharif* sowing estimates revealing an almost 23% shortfall and composite PMI data for July showing a persistent contraction in business activity and continuing job losses, it is hard to see either a near-term revival in demand or an easing in inflationary pressures from cereal and edible oil prices. Admitting the price pressures, the RBI has also raised its fiscal-year inflation projection by 60 basis points to 5.7%. Also, with one of the six members of the MPC dissenting and voting against the language of the policy stance, it seems clear the central bank may sooner than later have to bite the bullet and start normalising rates if it wants to avoid undermining its own credibility by delaying steps to rein in inflation.