The Recent Policy Rate Announcement by RBI

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The Monetary Policy Committee (MPC) released its fifth Bimonthly Policy Statement on December 6th 2017. The Committee is led by Reserve Bank Governor Urjit Patel. It is interesting to note that there was no unanimity in the decision among the MPC members to keep the rates remain at status quo.

Five out of six MPC members - Dr. Chetan Ghate, Dr. Pami Dua, Dr. Michael Debabrata Patra, Dr. Viral V. Acharya and Dr. Urjit R. Patel - were in favour of an unchanged repo rate, while Dr. Ravindra H. Dholakia voted for a policy rate reduction of 25 basis points. The final decision of the MPC was to keep the repo rate unchanged at 6 per cent and reverse repo rate at 5.75 per cent, but they raised the inflation forecast for the rest of the current FY (financial year) to 4.3-4.7 per cent. The details of the deliberations will be known only by December 20th when the minutes of the MPC's meeting will be published. However these debates about policy rates within the Central Bank are widely accepted by the economists and policy makers as healthy debates as it generates a public interest in knowing how the rates are set by the Central Bank.

The Monetary Policy Committee in India is constituted against the backdrop of amendment to RBI ACT 1934 to form a statutory and institutional mechanism of MPC members to decide the policy rates *instead of RBI Governor alone*. As a part of this major institutional reform in the macro policy making in India, signed by RBI and Government of India towards an "NMF" ("New Monetary Framework"), the objectives of the Central Bank were also re-written. After this institutional reform, the sole objective of RBI is to manage price stability. Since then, RBI has stopped following a multiple indicator approach in managing exchange rate, employment and growth along with inflation, and started focusing towards inflation targeting.

The MPC decision to keep the neutral monetary policy stance at 6 per cent is because of the reason that the inflation remained firmly under control with 4 per cent nominal anchor and economic growth has bounced back. Against the backdrop of Government's various reforms measures including GST, Bank Recapitalization package and improving the Ease of Doing Business ranking, the MPC has retained the economic growth forecast – the annual GVA (Gross Value Added) forecast - for FY 2018 of 6.7 per cent. In its Fifth Bi-monthly Monetary Policy Statement, 2017- 18, RBI said that "(T)he projection of real GVA growth for 2017-18 of the October resolution at 6.7 per cent has been retained, with *risks evenly balanced*," irrespective of the recent increase in global oil prices. In the 5th Bi-Monthly Monetary Policy Statement, the RBI has also cautioned about the "fiscal slippage" due to the reduction in indirect tax revenue on account of reduction in GST rates of 178 items from 28 per cent to 18 per cent; partial roll- back of excise duty and VAT on petroleum products; and farm loan waivers by some states. RBI noted that this "fiscal slippage" may fuel inflation.

The MPC report has also taken note of developments in global financial markets and US Fed, especially the trends in the bond yields, to take the decision to keep the rates at status quo to avoid capital being "flighty" to advanced countries due to interest rate differentials. However, there are criticisms and disappointment over RBI's decision to maintain neutral policy stance, saying that lowering the policy rates was significant to revive domestic demand and encourage private investment to accelerate economic growth.

The monetary policy transmission from the repo rates (the rate at which RBI lends to commercial banks) to deposit and lending rates is still unclear. Evidence shows that banks are unlikely to tweak either their deposit or lending rates aftermath to lowering policy (repo) rates. The benefits of policy announcements also depend on the effectiveness of "interest rate channel" mechanisms in Indian economy. It is incorrect to assume that lowering of repo rates "per se" triggers economic growth. Therefore it was a cautious decision by RBI Governor Urjit Patel to keep the rates unchanged. RBI Governor said that upward supply-side pressures from food and fuel prices and its impact on inflation expectations and evolving cost of living conditions is a major determinant to keep the rates at status quo.

The MPC policy decision is on the expected lines with the corporate sentiments. They have received the news with positivity. The pressures from headline inflation dynamics and trends in global financial markets including Fed decisions by Janet Yellen dominated the RBI's decision to maintain the rates at status quo. Janet Yellen, in her testimony of Fed decisions released in the end of November, gave hints to rise Fed interest rates further in future, which in turn has implications for capital flows in emerging economies. Therefore RBI's retention of rates of its neutral stance, ex-post to the recent big bang recapitalization programme for public sector banks is expected to trigger overall credit growth and private investment.