RBI as uncertain as the rest of us

The monetary policy committee (MPC) of the Reserve Bank of India (RBI) has left the repo rate unchanged at 6.25 per cent. The MPC appears to justify this, (in part) due to the uncertainty caused by a) the assumed imminent tightening of monetary policy in the US and b) the domestic impact of demonetisation or what the committee terms the "withdrawal of specified bank notes (SBNs)".

PUBLIC INTEREST

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The first action will have medium-term exogenous effects and holding rates is, therefore, understandable. On the second count, I am puzzled. RBI is a party to the decision to withdraw SBNs, an action ratified by its board. One would expect RBI to have analysed the implications of this decision, at least for monetary policy, and to have made this analysis explicit in the MPC statement. It appears that the RBI is as uncertain as the rest of us as it provides no such analysis. It speculates, like everyone else, that there could be aggregate demand compression and lower inflation in the next two quarters, and that the withdrawal of SBNs could interrupt industrial activity due to supply chain transmission effects but — like the rest of us — awaits "a fuller assessment".

Other than the lack of analytical clarity on the likely short-term disruptions caused by SBN withdrawal, I am concerned by the rather cursory economic analysis provided in the last two statements since the MPC came into existence. The MPC has voted unanimously twice, once to lower rates, and once to hold them constant. This indicated analytical agreement on the emerging economic situation and ought to also signal continuity of economic thought. However, I find myself confused by the several conflicting signals. This would be understandable if RBI were playing it by ear and not making claims to have a strong analytical basis for its economic reasoning. However, in the monetary policy report of October 2016, RBI claims to deploy a host of models to estimate growth and inflation aggregates. If so, one would expect consistency in intertemporal analysis of the Indian economy. I do not find this to be the case.

Take agriculture. The August MPC statement celebrated the success of the kharif crop. The October statement asserted that the outlook "has brightened considerably". This is reinforced by the December statement with respect to expanded Rabi sowing. Yet, the statement also says that "food inflation pressures could re-emerge". In the October statement, the committee expected strong growth in the second and third quarter of 2016 in both manufacturing and services. In the December statement, RBI notes that "industrial activity remains weak," this without factoring any negative impact of SBN withdrawal. Oddly, RBI cut interest rates when it reported a pick-up in manufacturing in October, but has chosen to hold them constant when it reported a decline in the same sector. This has nothing to do with SBN withdrawal but reflects wobbly analytics with respect to the response to the underlying growth trends of the Indian economy.

Each of the three independent members of the MPC asserted in October that a drop in interest rates is necessary to support growth. Clearly, this has not happened, as RBI has reduced its growth forecast by 50 basis points of the gross value added in its December statement. The Governor was somewhat more ambivalent and did indicate the need to monitor inflation going ahead as upside risks persist. While we must await the reasoning for the vote (again unanimous) by individual members, the December statement does not provide any reasoning on whether such upside risks have played out, but refers vaguely to indicators of underlying inflation and resorts to speculation regarding the future behaviour of discretionary spending on goods and services, on whether food prices will moderate given growth in output, and on the behaviour of global oil prices. It makes opaque statements such as "the committee took note of the upturn in the prices of several items that is masked by the easing of inflation on base effects during October". It provides no analytical explanation as to why weak growth should be accompanied by higher inflation risk. If the MPC judges that this is happening because the economy is hit by a combination of demand and supply shocks and, therefore, expects both lower growth, and increasing inflationary pressures, then this should have been clearly communicated and analytically justified. As things stand, RBI has left this for analysts to deduce, rather than making it clear that this was its own reading of the current economic situation.

Given the uncertainty caused by the SBN withdrawal, global uncertainties regarding the US monetary policy, and volatility in oil prices, the MPC is perfectly justified in holding interest rates even if markets are surprised. A clear statement that justified this decision given these uncertainties would have been both sufficient and desirable. However, the lack of continuity in analytical judgements in the October and December statements, and the vague and speculative nature of the discussion regarding the withdrawal of SBNs — a decision the RBI took and is, therefore, accountable for— in the December statement are unsatisfactory. Going forward, RBI needs to improve the quality of its communication and better explicate its policy stance without recourse to speculative reasoning in its assessment of the future behaviour of the Indian economy.

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