



A re-look into monetary policy structure needed



EXPERT
VIEW

N.R. BHANUMURTHY

Respond to this column at
feedback@livemint.com

The Monetary Policy Committee's (MPC's) decision to cut the repo rate by 25 basis points, although surprising, may be justified, especially when the CPI inflation, as well as its expectations, are subdued and well below the 4% target. The rate cut, together with the proposals in the statement on developmental and regulatory policies, suggest the MPC shifted its gears to revive private investments and, hence, growth. But the impact of this rate cut needs to be looked together with the interim budget proposals.

Upfront, a slight disappointment is about the MPC's assumption that GDP (gross domestic product) growth in 2018-19 is at 7.2%, while GVA (gross value added) growth is at 7%, based on first advance estimates, while considering the growth of 7.2% and 6.9% for 2017-18 for GDP and GVA, respectively, based on first revised estimates. However, if one takes the levels and re-estimates, the growth would be 5.9% and 5.8% for 2018-19 for GDP and GVA, respectively. Now what numbers (levels or growth rates) should one look at for output gap estimations, or for other monetary statistics, is something left to the Reserve Bank of India (RBI).

In terms of the impact, as the MPC statement indicates, the rate cut, as well as the changes in regulatory and development policies, is expected to revive private investments, while at the same time, enhance consumption demand. The MPC also expects the fiscal measures in the interim budget to improve disposable incomes. But the MPC also appears to be too lenient towards the government's fiscal slippage for two consecutive years and, most importantly, to the deteriorating quality of public expenditures. One would have expected the MPC to look at the comments made by the comptroller and auditor general (CAG) in its recent report.

In the rate cut, it is intrinsically assumed that it would boost investment demand. However, what is empirically found is that there is a weak relationship between interest rates and invest-

ment demand. And, this would also depend largely on the transmission mechanism, which, in my view, is weak, given the stress in the banking industry. In such a situation, the rate cut could potentially lead to an increase in consumption demand and dampen savings, which could have a second-round impact on interest rates and investments. Given the banking sector's stress, what was required now were policies that could revive savings.

On the growth front, the MPC clearly states that there are downside risks, especially from global economic activity, which is largely clouded. There are expectations made by many respectable institutions and analysts that there could be another round of recessionary conditions in 2019, especially when one looks at global commodity prices. While this could dampen the domestic services sector, it may not be good news for India's exports either. In such a situation, the recent macro policy measures (populist budget and interest rate cut), will have, if at all, less impact on reviving growth, and a larger impact on inflation.

That apart, the MPC report gives a feeling that interest rate policy is used only for either inflation control or to revive growth. But there are other open-economy macro issues that need equal focus while setting interest rates. While one could argue it is not the mandate of the MPC, there are very limited instruments left for the RBI, other than interest rates, to address the issues on capital account. And my guess is that, this could be one reason why two members of the MPC dissented the rate cut at this stage. RBI governor Shaktikanta Das in the post-MPC press conference said that India has enough foreign exchange reserves (of \$400 billion after a reduction of almost \$30 billion recently). We can

only hope that due to today's rate cut, we are not missing the policy space required when there is a crisis on external account. This brings to the question of how far the inflation targeting regime is relevant for countries such as ours, where managing the external vulnerabilities are equally important. While MPC's shifting of focus on growth could be welcoming, any slight shift away from the external factors could be damaging. There may be some clue from the Sensex today, which has declined after the MPC announcement. In that sense, there is a need to have a re-look at the present monetary policy framework.

N.R. Bhanumurthy is professor at National Institute of Public Finance and Policy, Delhi. The views expressed are personal.

MPC also appears to be too lenient towards the government's fiscal slippage