Shifting to neutral

RBI has decided to prioritise inflation. But trade-off between managing prices and government's borrowing programme presents a challenge

RADHIKA PANDEY

THE FIRST BI-MONTHLY meeting of the Reserve Bank of India's Monetary Policy Committee (MPC) for the current financial year reaffirmed its focus on inflation management. While the MPC voted to keep the policy rate unchanged at 4 per cent and retained its accommodative stance, the wording was changed to "remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth." This statement sets the stage for a shift to a neutral stance in the next meeting and policy rate hikes in subsequent meetings. RBI has announced the withdrawal of some of the steps taken during the pandemic to support the economy. These will foster the normalisation of monetary policy.

The central bank has acknowledged that the disruptions caused by the Russia-Ukraine crisis have upended their growth and inflation outlook. It has steeply revised its inflation projection from 4.5 per cent earlier to 5.7 per cent now for the current financial year. The projection is based on an average global crude oil price of $100 per barrel. While oil prices could swing either way, elevated non-fuel prices pose a substantial upside risk to inflation. The Food and Agriculture Organisation's (FAO's) Food Price Index, a gauge of global food prices, posted a record growth of 12.6 per cent from February. The surge in the index was broad-based, driven by a rise in prices of vegetable oils, cereals, meat, sugar and dairy products. Input cost pressures emerging from a broad-based surge in prices of industrial raw materials and supply chain disruptions are also likely to pose a sustained upward pressure on inflation.

During the last monetary policy announcement, there were concerns that the RBI was falling behind the curve in managing inflation at a time when globally many central banks including the US Federal Reserve, and the Bank of England have started raising rates and signalling aggressive rate hikes and are reducing their balance-sheet to normalise monetary policy and tame inflation.

While the RBI has been managing liquidity infused into the system during the pandemic through the Variable Rate Reverse Repo Auctions (VRRR) to withdraw liquidity and Variable Rate Repo auctions to inject liquidity, it has now formalised the Liquidity Adjustment Framework (LAF). The LAF is a framework to absorb and inject liquidity into the banking system.

The RBI has introduced the Standing Deposit Facility (SDF) as the lower bound of the LAF corridor to absorb liquidity. The idea of the SDF was first mooted by the Urjit Patel Committee report on the monetary policy framework. The RBI Act was amended through the Finance Act of 2018 to allow RBI to use this instrument.

The SDF will be a facility available to banks to park their funds. The SDF will serve as the standing liquidity absorption facility at the lower end of the LAF corridor. At the upper end of the corridor is the Marginal Standing Facility (MSF) to inject liquidity. With the introduction of the SDF, the fixed rate reverse repo rate seems to be defunct. Through the SDF, the RBI can absorb liquidity without placing government securities as collateral, hence it will give greater flexibility to the central bank.

The LAF is now a symmetric corridor with a width of 50 basis points. The policy repo rate is at the centre of the corridor, with the MSF 25 basis points above the policy rate and the SDF 25 basis points below the policy rate.

The change also marks a shift away from reverse repo being the effective policy rate. During the pandemic, the reverse repo rate was reduced to incentivise banks to park lesser funds with the RBI and lend more. This led to the breakdown of the symmetric LAF corridor. With the introduction of the SDF, the RBI has reverted to a symmetric liquidity management corridor.

While on the face of it, there are no rate hikes, the shift from the reverse repo rate to the SDF signals a tightening of monetary policy. There is a 40 basis points increase in the floor rate. It may be argued that the RBI has been absorbing liquidity through variable reverse repo auctions where the cut-off rates are closer to 4 per cent. In the medium run, the call money rate would move towards the new LAF corridor, thus bringing orderly conditions in the money market.

During most of February and March, yields on government bonds were range-bound as a number of auctions were cancelled. But since the announcement of the half-yearly borrowing programme, yields have been inching up. The government is expected to borrow Rs 8.45 trillion in the first half of the current financial year. While there were no explicit announcements to cool the yields, through measures like G-SAP, Operation Twist and Open Market Operations (OMOs), the RBI raised the limit under the held-to maturity category for banks from 22 per cent to 23 per cent. This move will insulate banks to a certain extent from mark-to-market losses as yields inch up. It will likely ensure demand for government bonds by banks.

As RBI begins to normalise liquidity in a calibrated manner, its ability to manage bond yields will likely be limited. Yields on bonds are likely to inch up and remain above the 7 per cent mark. Going forward, the trade-off between managing inflation and the borrowing programme of the government will become challenging. For now the RBI has rightly decided to place top priority on inflation management. This will help in maintaining the credibility of the inflation targeting framework.

The writer is Senior Fellow, NIPFP. Views are personal