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RBI faces monetary policy dilemmas



The fine print of RBI's monetary policy statement shows both inflation and growth remain worrisome.

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Our central bank will need to address risks generated by its own and the US Fed's extraordinary monetary easing.

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As widely expected, the Reserve Bank of India (RBI) once again left its negative real policy rate unchanged in the monetary policy announcement of 8 October. The ground macroeconomic situation had not materially changed over its last few policy announcements. If anything, its dilemmas have magnified.

First, despite the brave face put up in the statement, the fine print indicates that both inflation and growth scenarios remain worrisome. RBI's own expectation of consumer price inflation is upwards of 5% and very near the upper limits of its tolerance level of 6%. Household expectations are considerably higher. The inconvenient truth is that growth, investment and employment are still to revive beyond the low pre-pandemic rates, and we could be entering stagflation territory.

Second, the threat of a reversal in US Federal Reserve policy sooner rather than later has increased following the Fed Chair's Jackson Hole speech, and recent Federal Open Market Committee announcements. Inflation has persistently exceeded the Fed's forecasts, even as growth has been robust. Economists such as John B Taylor, author of the eponymous 'Taylor Rule' for monetary policy, and *The Wall Street Journal* are describing the persistence of near-zero (nominal) policy rates under the current Fed Chair as the most reckless since Arthur C. Burns, whom history has held accountable for igniting the great inflation of the 1970s. If inflationary pressures do not subside, the Fed will be forced to act.

The Federal Reserve and RBI confront dilemmas that are similar, but only up to a point. Both have persisted with negative real interest rates to drive up growth, adding to inflationary pressures. Both have been able to keep bond yields from rising through aggressive market intervention and expansion of their balance sheets that have inflated stock market booms.

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A close reading of the RBI governor's statement indicates that monetary policy is now an extension of fiscal policy. Banks and other financial institutions that buy long-term sovereign bonds in the primary market are funded by RBI through its repurchases in the secondary market (it is no longer permitted to pick these up directly from the treasury), i.e. through expansion of its balance sheet. During the three financial years ending 31 March 2021, RBI's stock of government securities has more than doubled from 3.7% to 6.8% of gross domestic product (GDP), including by 1% over the last year alone. During this three-year period, another 1.7% of GDP was paid out as dividend to the treasury. Liquidity adjustments on a day-to-day basis are managed through repo and reverse repo operations.

RBI's recent initiative to retail government securities directly to individual investors is indicative of its intent to continue its bond purchases. It may, therefore, persist with an accommodative monetary policy longer than market participants expect.

The Fed can persist with near-zero lower bound rates because it has the 'exorbitant privilege' of working with the global reserve currency for which there appears to be a bottomless appetite. Its monetary policy drives the global financial cycle and cross-border capital flows. Other countries, especially emerging markets and developing economies such as India, mimic the Fed at their own peril as they risk market revolt.

The Fed, moreover, can take a more benign view of inflationary pressures because it has a dual policy target that gives equal weightage to growth and inflation. It sees current inflationary pressures as transient that and expects them to ease as pressure on supply chains softens with the opening up of the economy.

Inflation, on the other hand, is the primary policy target of RBI, with price stability as "a necessary precondition to sustainable growth". Like the Fed, RBI considers inflationary pressures as transient. But economists and market participants worry that if inflationary pressures persist, both central banks would be forced to reverse policy and raise rates.

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Unlike the Fed that confronts an overheating economy, RBI finds itself somewhere between a rock and a hard place, with growth remaining below trend. It is transfixed like a deer in the headlights of a car at night, unable to decide whether to hold/lower rates or raise them. There is no monetary policy solution for stagflation. Raising rates will not help because

inflationary pressures are on the supply- and not demand-side. Pumping more easy money to stimulate growth will only drive inflation and asset prices still higher.

There would, however, be no escape for RBI if it were confronted with the trilemma arising out of a reversal of US monetary policy. Unlike China, and several other Asian countries, India's foreign exchange reserves are not a result of an accumulation of trade surpluses. India runs a structural current account deficit that needs to be financed through capital inflows. Its foreign exchange reserves have been built on the back of a Fed -induced global financial cycle, which has sent a flood of capital into emerging markets in search of higher yield, as the Fed has kept US interest rates at the zero bound for an extended period through a sustained expansion of its balance sheet.

If this cycle turns, India could bleed foreign exchange reserves and the central bank would be constrained to raise rates to maintain macroeconomic stability. Rising fuel prices would aggravate the situation. Based on comparative extant macroeconomic indicators, the experience of the 'taper tantrum' indicates that India could be among the worst-affected emerging markets. In such a situation, RBI might be forced to act.

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