

Views on monetary policy (April 2008)

Fine Balancing Act

RBI governor Dr. Reddy has chosen to maintain a status quo on policy interest rates while increasing the cash reserve ratio by another 25 bps to 8.25%. RBI is walking a tightrope to balance the twin objective of supporting growth while maintaining price stability.

The case for a rate hike was based on the fact that RBI needed to send a strong signal to suppress inflationary expectations. A combination of elevated commodity prices, expansionary fiscal policy and loose money could lead to build up of long term inflationary expectations and a situation of wage-price spiral. But it seems RBI expects inflation to soften over the next few months as impact of fiscal and supply side measures take effect. While the central bank has mentioned price stability as its key priority, the overall undertone of the policy is not as hawkish as market feared. There seems to be a realisation that higher rates are hurting growth particularly in the interest rate sensitive sectors. Heightened uncertainties in global economy and markets are adding to the complexities the central bank is faced with.

Unexpected hike in CRR indicates that RBI's preferred tool would continue to be liquidity management and they would use CRR and MSS to ensure that systemic liquidity (as measured by outstanding in daily LAF) at best remains balanced.

RBI is unlikely to use exchange rate as a major tool to fight inflation. It can't afford a sizeable appreciation that could have meaningful impact on import prices. Exports, particularly employment intensive industries, are already under tremendous pressure. Current account could deteriorate further while capital flows are already slowing down.

The RBI has mentioned that it has 'headroom' available on interest rates and will now watch incremental economic data and events going forward to decide on further policy action. We don't rule out possibility of an inter-meeting action by RBI in case price situation warrants it. After all, surprise to market is a key element in governor Reddy's monetary policy operations. We like that!

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