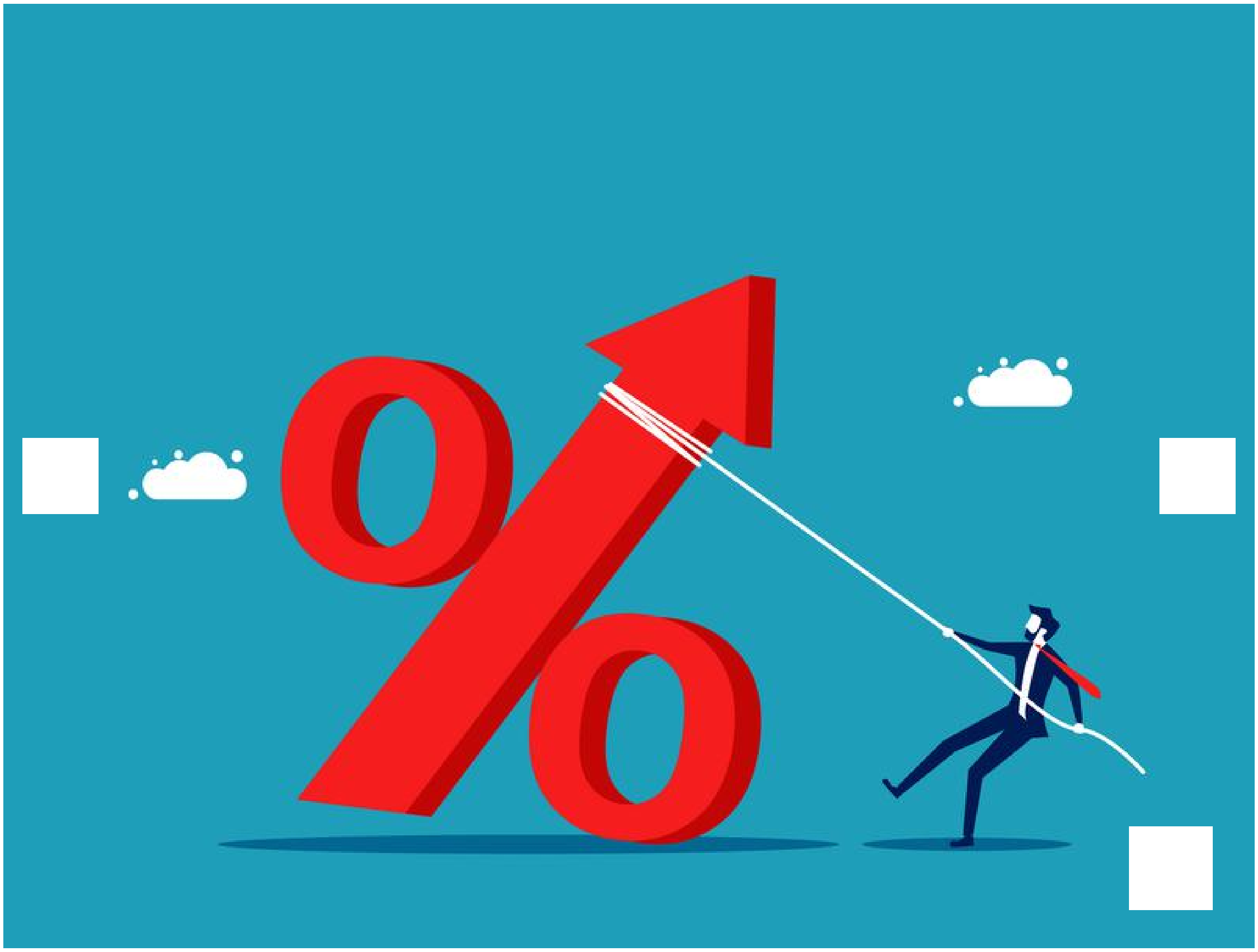
RBI could consider cutting policy rates

Change tack. RBI has to pivot sooner or later, else interest costs may prevent private investments from picking up



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Inflation-growth relationship is non-linear. While low inflation helps growth (greases the wheels of commerce), high inflation harms growth (puts sand on the wheels of commerce). In India, the threshold level of CPI inflation (with maximum growth) was around 6 per cent earlier. Hence, the inflation target was set at 4 per cent with a tolerable band of +/-2 per cent. The threshold inflation in India (beyond which it harms growth) seems to fallen to 5.5 per cent recently (*Journal of Quantitative Economics*, March 2024 by the author) although the tolerance band has remained unchanged. This could be attributed to the flexible inflation targeting (FIT) pursued since 2016, which delivered price stability except during the Covid-19 outbreak and its aftermath.

Inflationary pressures in the post-Covid period were not only contributed by an unprecedented supply shock but also due to highly accommodative monetary and fiscal policies. The RBI's liquidity support during the post-Covid period was unusually high similar to many other countries to revive the economy quickly. It was also argued that inflationary pressures, particularly from food items, persisted longer than expected following repeated supply shocks. This could not be anticipated in advance leading to forecast inaccuracy. Moreover, the RBI was cautious about the second-round effect of supply shocks that spill over to the non-food segments leading to generalised inflation. Hence, the RBI sticks to tight monetary policy until the headline CPI inflation is enduringly secured at 4 per cent. As monetary policy is forward-looking, the policy rate is set based on forecasts rather than realised inflation. For July-August 2024, India's retail inflation was below 4 per cent. According to the RBI's latest inflation forecast, the CPI inflation is expected to remain around 4.5 per cent by March 2025. It is anyway within the tolerance band, rather close to the target.

The flexibility clause embedded in the FIT permits the MPC to tolerate CPI inflation slightly above the target, particularly when the underlying cause is inadequate supply response. India may have a record level of agricultural output in FY25 following an above-average monsoon, which may soften the food prices considerably. Moreover, inflation undershooting cannot be ruled out in a disinflationary situation.

Spillover effect

Food inflation is certainly a supply-side problem. However, spillover of food inflation to core inflation was not convincingly observed in India, at least recently. Since December 2023, India's core CPI inflation softened below 4 per cent despite food inflation remaining elevated. During the last two months, food inflation has softened, but core inflation has started looking up indicating a weak link between food inflation and core inflation.

Food inflation in India is a structural problem. Total foodgrain production has been impressive in recent years. Moreover, India is the second largest producer of vegetables, next to China. Despite improvement in the 'terms-of-trade' in favour of agriculture *vis-à-vis* industrial products, resources have not been reallocated in favour of farm products. The reasons are well-known. Hardly 30-40 per cent of the retail prices of farm products reach farmers.

The value chain in agriculture is exploitative. Both consumers and producers suffer in the process. As farmers do not benefit from favourable terms of trade, the reallocation of resources in favour of farm products does not occur. The problem needs to be resolved through next-generation reforms in both product and factor markets. In the short-run, the government is trying to address the structural problem through supply management, which is not an enduring solution to the structural problem.

Many central banks have started the rate-cutting cycle to prevent growth sacrifice.

The US Fed's 50 basis points (bps) cut in September 2024 was proactive despite the retail inflation stubbornly remaining above the 2 per cent target. Although the US is not an inflation-targeting country, the Federal Open Market Committee preferred to support growth/employment without securing inflation at 2 per cent on an enduring basis.

The RBI has not changed its policy rate and monetary policy stance since February 2023 although two external MPC Members recently voted differently. India's output gap seems to have closed. India's real GDP growth continued to maintain resilience although the first quarter GDP growth was below the RBI's projection. The MPC with new external members will take a call next week regarding the exact time to pivot.

India's real policy rate at 2.8 per cent (repo rate minus latest inflation rate) is well above the equilibrium real interest rate of 1.5-2 per cent. The credit growth in the first half of FY25 (up to September 6) has decelerated to 3.7 per cent compared to 5.6 per cent during the same period last year. The RBI has to pivot sooner or later failing which interest cost may harm private investment to gather momentum. The market has factored in a 25-bps repo rate cut as evidenced by the 10-year benchmark yield falling by similar magnitude in the first half of FY25.

The space available for rate cuts is limited. In a Goldilocks situation — inflation at its target and output at its potential —the neutral policy rate in India could be 5.5-6 per cent. If one goes by a 2 per cent real interest rate (inflation at 4 per cent), RBI can reduce the repo rate by 50 bps in H2 of FY25. If headline CPI inflation softens to around 4 per cent by March 2025 (against the projected 4.5 per cent), the RBI may extend the rate-cutting cycle to FY26 by another 50 bps.The *Economic Survey* suggested targeting core inflation instead of headline CPI inflation. From the consumers' perspective, excluding food inflation is not advisable. Even if the base year of the CPI inflation is revised the weight of food and beverage would remain high.

Historically, India experienced several instances of core inflation remaining much higher than food and fuel inflation. Most inflation-targeting countries target headline inflation, except a few countries like Uganda and Thailand. While the FIT framework can deliver price stability, the government has to shoulder supply-side management, including structural reforms.

The writer is an RBI Chair Professor at Utkal University and former Head of the Monetary Policy Department at RBI. Views are personal

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