RBI MPC Minutes: Flickers of a neutral stance

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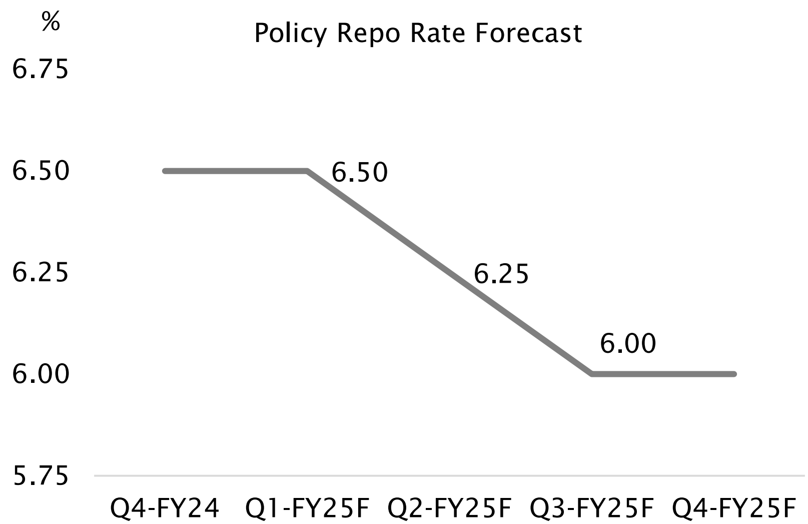
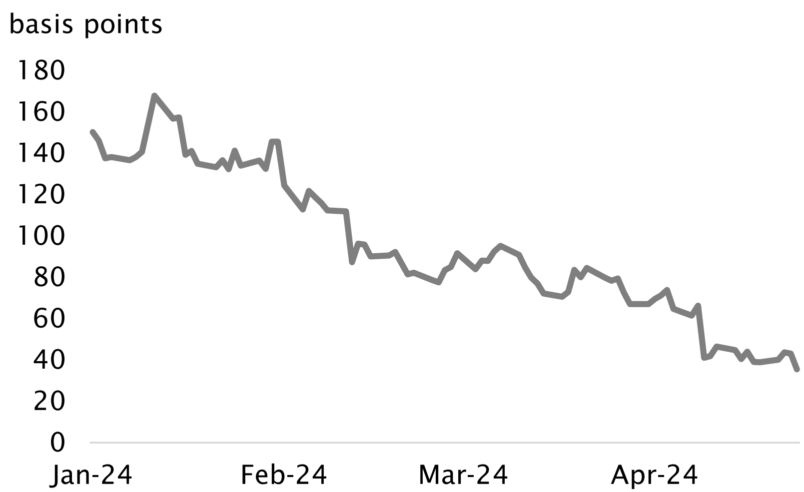
Key takeaways : Minutes of RBI MPC meeting, April 2024

At its bi-monthly meeting held in April, the RBI MPC kept its policy stance and rate unchanged for the seventh consecutive time. The forecasts for growth and inflation were also unchanged for FY25 vis-à-vis its previous meeting at 7.0% and 4.5%, respectively. The minutes of meeting suggest an additional external MPC member leaning towards a neutral stance, sans an explicit adjustment. However, some of the compelling arguments made by the member indicate that a change in policy stance could be underway in Q2, i.e. at its August meeting, which happens to be the last meeting for the existing external members of the MPC and also coincides with the period (Q2:FY25) when headline inflation is expected to slip below 4% target (as per RBI MPC April forecasts). It is highly likely that an additional member or two align towards a neutral stance in the upcoming meetings. A gradual change in stance would not only lay a fertile ground for the MPC to actually tweak rates at some point, if required, but also prevent de-anchoring of inflation expectations and financial market volatility. Recent MPC minutes show instances where observations of some of the MPC members were influential in shaping the central bank's actions, be it in terms of regulatory measures or liquidity management.

RBI Survey of Professional Forecasters: Apr-2024



Market pricing of Fed policy rate cut by Dec-2024



A tale of two dissenters

At its latest bi-monthly meeting, the RBI MPC kept both policy stance and rates unchanged for the seventh consecutive meeting. The forecasts for growth and inflation were also unchanged for FY25 vis-à-vis its previous meeting at 7% and 4.5%, respectively. However, **minutes of the meeting indicate that a change in policy stance towards "neutral" from the existing "withdrawal of accommodation" could be underway in Q2, i.e. at its August meeting, which happens to be the last meeting for the existing external members of the MPC and also coincides with the period (Q2:FY25) when headline inflation is expected to slip below 4% target (as per RBI MPC April forecasts)**, paving the way for flexibility in H2-FY25 for the central bank to carve its path based on the external and domestic environment at that time. **A gradual change in stance would not only lay a fertile ground for the MPC to actually tweak rates at some point, if required, but also prevent de-anchoring of inflation expectations and financial market volatility, which has been roiling financial markets, particularly in the US.** The expectations of a rate cut have been waning in the US, as indicated by the futures market pricing, declining from around 150 basis points (bps) at the beginning of the year to around 25-50bps at present. Domestically, the latest round of RBI's Survey of Professional Forecasters (SPF) suggests expectations of 50bp cut in CY24, one each of 25bp in Q2 and Q3.

Of the six-member MPC, **Prof. Jayanth Varma** is currently the sole dissenter, voting for a change in policy stance to neutral. **At the February meeting, he also voted for a 25bp rate cut and in addition to the argument regarding the impact of high real interest rate on growth, he noted that the process of fiscal consolidation that is expected to continue in FY25 could give room to monetary policy easing.** This is one area where India probably differs from some of the advanced economies where fiscal support continues unabated and public debt levels are expected to remain high, as also noted by the RBI Governor Shri Shaktikanta Das in the recent MPC meetings. As per the Union Interim Budget for FY25, fiscal deficit is budgeted to moderate to 5.1% of GDP from 5.8% in FY24. This does suggest that **in the absence of support from fiscal spending and external sector uncertainties, the onus of supporting domestic growth would need to be largely borne by monetary policy**, and the perspective of the impact of high real interest rate on growth is something that the policymakers might get mindful about.

Another external MPC member who kept her **vote on policy stance unchanged but put forth arguments in favor of a neutral stance was Dr. Ashima Goyal.** Some of the compelling observations made by her are noted here:

Arguments in favor of a neutral stance

- Further enhancing Prof. Jayanth Varma's arguments on the impact of higher real interest rates on growth, **Dr. Goyal noted that even if the natural or neutral interest rate (NIR), presently assumed around unity, is raised by about 50bps to 1.5%, policy would remain contractionary even with a repo rate cut.** Real policy rate is currently at 2% in terms of expected FY25 headline inflation (4.5%), and even higher in terms of expected core inflation (3.9% based on latest round of RBI SPF survey). However, considering the headline forecast, **this does imply room for only 50bp cut in the current cycle for policy to become neutral.**

- Another observation by Dr. Goyal was that there is no guarantee that once inflation reaches 4%, it will remain there in case of large shocks to the economy. **"Core sustaining near target inflation and average headline below 5 implies a credible approach to target, since research for the FIT (flexible inflation targeting) period suggests long-run causality continues to be from core to headline inflation".** In addition to confirming this, **a recent RBI study on the effect of supply shocks to inflation noted that the impact of food price shocks on core inflation has moderated post the adoption of FIT regime.** The response of core inflation to a one percent rise in food inflation has moderated from 0.37 percentage points in late 1990s to around 0.14pp in recent times. **This should allay fears of some of the MPC members of food price shocks feeding into core inflation.**

- Dr. Goyal also echoed similar sentiments on supply side shock woes, noting that "**while there are risks, there are also reasons to expect moderation in future supply shocks and their impacts**—such as improved governance and steady rise in investment reducing bottlenecks and logistics costs; resilience rising with development and diversity; El Nino changing to La Nina; the impact of substitution away from oil, of LPG and petrol-diesel price cuts and falling weights of volatile price items such as food in consumption baskets."

- Dr. Goyal also noted that **if core inflation is less than 4% and continues to fall despite strong economic growth, it suggests that there is no over-heating or excess demand. A similar point was made by Dr. Michael Debabrata Patra, who noted that the output gap had closed, contrary to his opinion in the December MPC minutes, when Dr. Patra was of the opinion that the output gap was positive.**

The third hidden dissenter

- In addition to aligning headline CPI inflation to RBI's 4% target and keeping inflation expectations anchored, the MPC has been suggesting that it was awaiting fuller transmission of previous policy rate hikes as a reason to keep policy rates and stance unchanged. However, Dr. Goyal made an interesting observation in this regard, noting that **non-food credit of banks accounted for less than half of annual flow of resources available to the commercial sector over 2007-23, implying that competition from other sources could translate into less than full transmission of policy repo to loan rates.** If this argument holds water, then the MPC might not need to wait for further transmission of rates to make policy changes.
  - While the MPC members had remarked about incomplete (Dr. Shashanka Bhide) or slowing (Dr. Rajiv Ranjan) transmission of previous policy rate hikes as per February MPC meeting minutes, the Governor merely acknowledged in the minutes of the latest meeting that the policy transmission is continuing.

- **Though Dr. Goyal did not explicitly vote for a neutral stance in April, citing the impact of varied uncertainties and the importance of maintaining stability, it is highly likely that she would do so in the upcoming meeting in June with another member or two joining the bandwagon to have enough majority by August MPC meeting. The reason for a gradual pace of change in stance would be to keep inflation expectations anchored and to avoid financial market volatility.**

- Another interesting point to observe was in the statement by Dr. Rajiv Ranjan. **Dr. Ranjan put forth all the right arguments, noting the MPC's approach of – caution, consistency and credibility – that justified a patient, data-dependent mode in the current context. However, he also noted how unpredictable the macroeconomic setting could get, which would require a flexible approach on the MPC's part.** Below are few such comments:
  - "The financial year 2022-23 is not far behind when all our assumptions and projections got altered within a month's time because of unforeseen events."
  - "To recall, just before we embarked on the path of monetary tightening, it was our endeavor then not to give up the accommodative policy setting till growth takes root and becomes self-sustaining. The fall out is that today growth is on a sustainable path despite monetary tightening."
- This suggests that while the MPC might remain in a cautious, data dependent mode, it would also be flexible and sensitive to changes in the macroeconomic backdrop. **This indicates more of a neutral view, rather than a restrictive one.**

Cues from recent MPC minutes

- It is important to note here why Dr. Goyal's observations in the latest minutes of the MPC meeting hold value and could influence the upcoming MPC meetings. **As per recent MPC minutes, some of Dr. Goyal's comments have been instrumental in shaping the central bank's actions.**
- **October MPC minutes**
- While the announcement of likely OMO sales as a part of managing liquidity had soured sentiment in the bond market, MPC minutes indicate that Dr. Goyal was the sole MPC member who had recommended this tool, though her suggestion for **using OMO** was in either direction depending on liquidity conditions.
- Dr. Goyal had also suggested prudential tightening, such as **raising LTV ratios or risk weights**, to curb sudden rise in retail loans and household debt. This was followed by the central bank's announcement of regulatory measures in mid-November towards consumer credit and bank credit to NBFCs by increasing risk weights.
- Dr. Goyal noted how **liquidity deficits lead to hoarding and more leakages**, and the need to develop an active overnight inter-bank call money market. While not a very drastic measure, in the December meeting, the MPC announced reversal of liquidity facilities under both SDF and MSF during weekends and holidays to address the skewed distribution of liquidity.
- **December and February MPC minutes**
- December minutes show Dr. Goyal mentioning that "while under the current stance WACR may stay largely in the upper half of the LAF corridor, it cannot persistently exceed it," followed by **strong arguments in the February MPC minutes for the WACR to ease**. By the time of MPC's April meeting, there was already a softening bias in the WACR, with a narrowing spread over the repo rate.

- There can be no certainty to outcomes, given the fluidity of external environment, particularly the shifting views on the start of monetary policy easing cycle by systemic banks, the impact of geopolitical tensions on commodity prices, and climate-related uncertainties. However, based on the examples cited above, Dr. Goyal's observations in latest MPC minutes could hold useful information to gauge the trajectory of policy stance, if not an outright rate cut, the expectations of which have been pushed back even in the global context.

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