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by Pravakar Sahoo

Repo rate hike may be a tough but crucial call

THE MONETARY Policy Committee (MPC) of the Reserve bank of India has hiked the repo rate, the rate at which the commercial banks borrow money from the RBI, by 25 basis points on June 6 after four-and-a-half years from 6 to 6.25 per cent.

The MPC's decision was unanimous and on the expected lines. The last hike was in early 2014 where the repo rate ascended to 8 per cent but since then the subsequent easy monetary policy brought down the repo by 200 basis points.

Given the inflation targeting mandate of the RBI, the central bank has opted for a pro-active step to curb rising inflation and inflationary expectations. In many ways the rate hike is justified given the rise of Consumer Price Index (CPI), sharp rise in international crude prices, depreciation of rupee, increase in private consumption expenditure and closing output gap. However, it has come at a time when the economy is on the growth momentum towards 8 per cent after demonetisation shock and GST teething problems. In fact, the most important factors for the economy such as private investment and credit growth, which were slowing and at the lowest level in the last decade, have started reviving in last couple of quarters and the rate hike now would make the cost of capital higher and might just slow down the growth momentum.

Monetary policy

There are justifiable reasons for the RBI to opt for a contractionary monetary policy. CPI increased from 4.28 per cent in March to 4.58 per cent in April' 2018, which is above the inflation targeting of 4 per cent though very much within the bandwidth of plus and minus 2 per cent. Wholesale Price Index (WPI) also increased to 3.18 per cent in April from 2.47 per cent in the previous month. The spike in prices in April was mainly due to food and fuel inflation. Apart from fuel and food, the other core categories that had higher inflation in April were housing, education, clothing, etc, due to increase in private consumption expenditure.

This food and oil prices are out of the government control as food inflation depends mostly on a favourable monsoon and oil price is determined by international market situation and oil-producing countries. The RBI is projecting the inflation range to be 4.8-4.9 per cent in the first half and 4.7 per cent in second half of 2018-19. The expected increase in crude oil price due to geopolitical reasons and prices of primary commodities due to spurt in consumption expenditure led the RBI to hike the rate to contain the price rise. Further, increase in minimum support prices for agricultural products may also put pressure on the price level.

International crude is increasing fast and India is importing 80 per cent of its total oil consumption. High cost crude oil, which is one of the major inputs for economic activities, affects overall price level across the board including consumer goods. The lower crude prices in the first two years of the NDA regime helped the government reduce the fiscal deficit by little over 1 per cent of GDP, but now higher crude price will affect both fiscal balances and current account deficit. RBI must have factored in these factors as well for the rate hike.

The rise in the crude price was triggered when US President Donald Trump withdrew the nuclear deal with Iran on May 8, 2018. Moreover, Venezuela's economic and political instability and recent deterioration in oil supplies have led to the increase in oil price. As India imports significantly from Iran and Venezuela, the developments affect the oil prices and import bill of the country. Retail price of petrol and diesel, around ₹80 and ₹70 per litre currently, are skyrocketing and reaching the highest level in last five years.

No GST regime

Since pricing of petroleum products has been deregulated and the sector has been kept outside the GST regime, every state has different VAT and dealers' commission which results in higher and different fuel prices across states leading to higher transportation cost and overall price level. The RBI had the projection of $68/barrel in April, but the prices rose to $80 in May 2018 creating miscalculations in inflation rate.

The fear of slippage in fiscal deficit, deterioration of current account deficit amid the rise in oil price, and net selling by the foreign investors resulted in sharp depreciation of nominal value of rupee reaching ₹67 per dollar from ₹64 per dollar a few weeks back. The rise of imports prices due to depreciation will contribute to the price rise through exchange rate price rise. India's current account deficit widened to $13.5 billion in March 2018 compared to $7.2 billion in December 2017. The slowdown of foreign investment led to further depreciation as FDI in 2017 was $29,645 million as compared to $35,617 in 2016. Moreover domestic factors like bank scandals, fiscal slippage and current account deficit don't augur well for the India's credit rating, investment and FDI inflows.

High growth

The output gap, the difference between actual GDP and the potential GDP, is closing due to revival of the economic activity and may tend to raise price level. RBI has projected around 7.7 per cent GDP growth in the fourth quarter of 2018, but the growth forecast tended to be around 7.4 per cent. This can create the output gap in the country leading to more inflation.

The repo rate hike will affect important sectors like construction, automobiles, etc, as banks will pass on the hike by increasing interest rate on loans. Several banks have already increased their lending rates by 10 basis points. The credit off take, which started rising in last couple of quarters and crucial for the growth, may moderate again.

The private investment, which started reviving in recent quarters after long continuous slow down in recent years, may find it difficult to absorb the rate hike. It is hoped that inflation gets moderated around 4 per cent and there is no further hike by end of the year due to monsoon, oil prices, increase in market support price, etc. Otherwise it would dampen investment, economic activity and squeeze the fiscal space for the government.

The writer is Professor, Institute of Economic Growth, Delhi. The views expressed are personal