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भारत सरकार

Economic Times , Delhi
Wednesday, 7th June 2017; Page: 14
Width: 17.37 cms; Height: 40.64 cms; a3; ID: 29.2017-06-07.116

Ease Policy Rates, Reserve Bank

Inflation targeting as framework, not policy rule

In preparing the second bimonthly policy statement for this fiscal, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) needs to view inflation targeting more as a framework than as a policy rule. The MPC needs to indicate easier cost of funds so as to improve sentiments, shore up demand and boost the faltering growth momentum going forward.

If seen as a rigid policy rule, there seems a solid case for the RBI to hold headline rates steady. As its Monetary Policy Report for April mentioned, while headline inflation did fall to a historic low, it is 'not broad-based' yet. The report added that the persistence of inflation, excluding food and fuel, poses a challenge to the inflation outlook. Further, it stated that there is considerable uncertainty as to how prices will pan out over the coming months. The report was sanguine that the recent appreciation of the rupee has had a 'soothing' impact on domestic inflation. But the fact of the matter is that it is arbitrage opportunities and high relative interest rates that are artificially attracting foreign funds to Indian shores.

Given that the trend in capital formation (read: investment, especially corporate investment) has been weak for years, the hardening rupee is not due to improved fundamentals and productivity gains. Keeping policy rates unchanged will merely aggravate inflows. Instead, taking into account the ground reality of decelerating GDP growth in the January-March 2017 quarter and weakening capital formation, it would make better sense for the MPC to consider inflation targeting as a flexible framework and purposefully indicate lower policy rates. Yes, the continuing problem of unresolved non-performing assets (NPAs) in the banking sector is a drag on credit offtake, and weakens the transmission mechanism for monetary policy initiatives and revised interest rates. However, in a regime of declining inflation, high and rising real rates of interest are wholly avoidable — especially with margins under pressure and a sharp decline in profit growth. So, ease policy rates, RBI.