EDITORIAL: BUSINESS LINE

GENERAL STUDIES 3: ECONOMY
TOPIC: INFLATION MANAGEMENT **DATE: 11.12.2024**

MANAGING INFLATION GETS PRECEDENCE OVER GROWTH

SIGNALS NEEDED. In the current context, it would have been appropriate if the RBI provided forward guidance on policy rates

Focus on Price Stability Over Growth

- In its December 6, 2024, resolution, the **Monetary Policy Committee (MPC)** placed a greater emphasis on **price stability** and **liquidity management**, sidelining economic growth considerations.
- Real GDP growth for Q2 of 2024-25 slowed to **5.4%**, a sharp decline from the **8.1% growth rate** recorded in Q2 of 2023-24. Despite this significant slowdown, the MPC opted to maintain the **policy repo rate** at **6.5%**, with the decision reflecting a **4:2 voting split** among its members.
- The outgoing Reserve Bank of India (RBI) Governor justified this approach, stating that achieving **durable price stability** is indispensable for creating a strong and sustainable foundation for high economic growth in the long term.

Revised Economic Projections Reflect Challenges

- The MPC revised its projections downward for **real GDP growth** and upward for **Consumer Price Index (CPI)-combined inflation** in its December resolution compared to the October forecast.
- The October 2024 CPI inflation rate hit **6.2%**, the highest level since 2023. This spike, combined with the Q2 GDP slowdown, was termed an **"aberration"** by the Governor.
- Projections for Q2 of 2025-26 suggest a reversal of this trend, with GDP growth forecasted to rebound to **7.3%** and CPI inflation anticipated to fall to **4%**.

Key Challenges to Optimistic Economic Projections

- Several uncertainties cast doubt on the feasibility of achieving the optimistic projections for both growth and inflation:
  - The **manufacturing sector** has shown **subdued performance**, and urban demand remains weak, reflecting low **consumer and business confidence**.
  - Investment sentiment continues to waver, driven by concerns over global **geopolitical tensions** and **geo-economic fragmentation**, which may also cause volatility in **commodity prices**.

- The persistence of **fuel deflation** for 14 consecutive months through October 2024 could face reversals if global energy markets shift.
- **Monsoon unpredictability** and ongoing impacts of **climate change** add further risks to the economy.

- Achieving the mandated CPI inflation target of **4%** under the **flexible inflation targeting (FIT)** framework by Q2 of 2025-26 appears challenging under these conditions.

Contradictions in Growth and Inflation Estimates

- While the RBI stresses the importance of a **"disinflation glide path"** to stabilize prices, this is expected to come at the cost of economic growth.
- However, the inflation and growth projections in the MPC resolution present a seemingly contradictory picture:
  - **Inflation** is forecasted to drop from **4.6% in Q1** to **4% in Q2 of 2025-26**.
  - Simultaneously, **growth** is expected to rise from **6.1% in Q1** to **7.3% in Q2**.
- This dual expectation raises questions about the internal consistency of the projections, as achieving both disinflation and accelerated growth concurrently is highly complex.

Policy Repo Rate Stance: Stability Amid Debate

- The MPC has retained the **policy repo rate** at **6.5%** for the past **24 months**, signaling caution despite ongoing debates among members about the optimal monetary policy stance.
- Two MPC members expressed a preference for a **rate cut**, but the committee ultimately decided to maintain the rate.
- Since the October 2024 resolution, the MPC has adopted a **neutral stance**, allowing flexibility to monitor **disinflation trends**, economic growth, and other developments before making further decisions.

Concerns About Stagflation

- The October 2024 combination of high inflation (**6.2%**) and low growth (**5.4%**) prompted speculation that India might be entering a period of **stagflation**.
- However, the Governor dismissed this view as premature, arguing that it is based on limited data points and does not reflect long-term trends.

Liquidity Management Measures by RBI

- The RBI announced two key measures to address potential liquidity tightening due to **tax outflows**, increased **currency circulation**, and **capital flow volatility**:

  1. **Cash Reserve Ratio (CRR) Reduction:**
     - The CRR was reduced by **50 basis points (bps)** in two equal tranches of **25 bps** each, effective December 14 and December 28, respectively.

- This reduction will restore the CRR to **4%**, releasing approximately ₹1.16 lakh crore of liquidity into the banking system.

2. **Foreign Currency Non-Resident Bank [FCNR(B)] Deposits:**
    - Interest rates for FCNR(B) deposits were raised:
        - For maturities of **1–3 years**, the rate was increased from **ARR + 250 bps** to **ARR + 400 bps**.
        - For maturities of **3–5 years**, the rate was increased from **ARR + 300 bps** to **ARR + 500 bps**.
    - These changes are temporary and will remain effective until **March 21, 2025**.

Implications of Liquidity Measures

- The **CRR reduction** is seen as a positive step toward easing liquidity constraints.
- However, the increased reliance on **NRI deposits** to attract capital flows raises concerns:
    - **External debt** will rise due to the additional burden of interest payments.
    - As of June 2024, **outstanding NRI deposits** totaled **$194.1 billion**, accounting for **28.4% of India's total external debt**.
    - The repayment of these deposits will require a drawdown of **forex reserves**, potentially straining India's reserve position further.

Forex Reserves and Market Stability

- Forex reserves declined by **$17.76 billion** in the week ending November 15, reflecting RBI's intervention to stabilize the rupee.
- The central bank sold dollars to counter volatility in the foreign exchange market caused by capital outflows and a depreciating rupee.

Conclusion: Prioritizing Inflation and Liquidity

- The December 2024 monetary policy statement underscores the RBI's focus on **managing inflation** and **ensuring liquidity stability** at the expense of economic growth.
- While the RBI is cautious about the future movement of inflation, it expressed relative comfort with the growth trajectory, despite uncertainties.
- The Governor highlighted the criticality of **timing in monetary policy decisions**, indicating that prolonged growth slowdowns may eventually necessitate policy intervention, although forward guidance on rate cuts was notably absent.

Source: https://www.thehindubusinessline.com/opinion/managing-inflation-gets-precedence-over-growth/article68974080.ece#:~:text=In%20addition%2C%20it%20is%20concerned,management%20gets%20precedence%20over%20growth.