Rational policy pause

Food prices tend to obstruct the disinflation process

The first Monetary Policy Committee (MPC) meeting after the Lok Sabha elections rightly decided to leave the policy repo rate unchanged last week. Although the headline consumer price index-based inflation rate came down in recent months, it is expected to remain above the target of 4 per cent this financial year. However, the upward revision in growth projection surprised many on the street and helped push up the stock market. The MPC expects the Indian economy to grow 7.2 per cent this financial year, compared to the previous projection of 7 per cent. Notably, the Indian economy expanded by a higher than expected rate of 8.2 per cent in 2023-24. The upward growth revision reflects the MPC's view of sustained economic momentum. If the economy grows as projected, the current year will become the fourth consecutive year to record 7 per cent or more gross domestic product (GDP) growth.

In terms of policy action, the decision of the MPC to maintain the status quo — despite two of its six members voting for a rate cut — reflected the majority view that the disinflation process should be allowed to be completed. The headline inflation rate moderated to 4.8 per cent in April from 4.9 per cent in the previous month. While the headline rate remains significantly above the target, the core inflation rate moderated to 3.2 per cent in April, the lowest in the current series. The headline inflation rate is largely driven by food prices, but the outcome is not entirely surprising. Research findings featured in the Reserve Bank of India's latest Annual Report show core inflation in India, on average, takes a year to return to the pre-surge level in the absence of an overlapping shock. However, convergence in headline inflation to the pre-surge level is obstructed by food-inflation volatility. An analysis of the periods before and after the adoption of flexible inflation targeting (FIT) shows, while the timeline of movement in core inflation to the equilibrium is similar, owing to structural factors and policy transmission lags, the surge in the core inflation rate has been much lower after the adoption of FIT. This suggests better anchoring of inflation expectations in the post-FIT period. Therefore, convincing monetary policy action can help contain the surge in inflation rates.

Nonetheless, dealing with food inflation remains a challenge and its volatility is always hard to gauge. It is thus critical to wait till the target is durably achieved. A premature rate reduction can affect expectations and complicate monetary policy operations. A normal monsoon this year should help moderate food prices. Additionally, better than expected GDP growth provides the RBI the policy space to remain focused on inflation management. Further, it made sense at this stage to wait and see the fiscal stance of the new government, which assumed office after a largely unexpected verdict. There are concerns in the financial market that managing government finances will become more difficult, given the nature of the election verdict. A deviation from the fiscal consolidation path would have implications for inflation outcomes. Finally, while the stated stance of the RBI is that it doesn't follow the US Federal Reserve, it is wise to consider the Fed's stance, given the implications for capital flows and currency markets.