

## *RBI Watch*

Changing times and policy: RBI's Monetary Policy Oct. 2009

By

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First things first. In RBI's semi-annual monetary policy announced yesterday, Governor Subbarao did not put a foot wrong. And he got several feet right. The policy marked a departure from traditional RBI approach in several respects. There are two criteria by which the policy can be evaluated. Was what was done appropriate? Was what was not done correct? Let us examine both.

*What was not done:* The RBI kept the repo rate, and the CRR level, unchanged. This doing nothing policy best illustrates the likely new approach at the RBI. The monetary hawks were out in force, and echoing the demands of their compatriots in the developed world, contended that India must begin to rebalance and hike interest rates. After all, Israel and Australia had shown the way, and the RBI must also follow. Our repo rates were at lows induced by the crisis and this imbalance had to be redressed. If the RBI *had* followed, it would have struck a false note. Why? Because India's monetary policy should *not* be about matching what other countries have done, or are doing. Each country's monetary situation can be different. Prior to the crisis, India had one of the highest real interest rates in the world. If what Australia does is relevant, why weren't our rates reduced in 2007?

One long lasting impact of the financial crisis of 2008 is likely to be a new real interest rate approach to monetary policy in India – all for the better. According to this approach, real interest rates in India were inordinately high in India prior to the crisis. Adjusting back to those levels is neither desirable nor appropriate. For too long Indian policymakers have followed a biased and mechanical monetarist policy in setting interest rates. If money supply growth was just one percentage point above the *assumed* target, rates were hiked. A good monetarist respects symmetry, but that is not what the RBI did in most of its post-reform history. If money supply growth was below target, it said it needed to cool the ostensibly overheated economy and/or to cool inflationary “expectations”. If above target, wham. No more. Reading between the lines of both the review of the economy and the policy announcement, it now appears likely that the money supply growth policy indicator will go the way of the telegraph. In this email world, sooner is not soon enough. But better late than never.

*What was done:* The RBI increased the SLR requirement from 24 % to 25 %, and raised the risk weight on loans to real estate. The former would fall in the category of “tone”; prior to the crisis the SLR was 25 %, so we are back to “normal”. However, since banks are already depositing close to 27 percent (lazy banking again?), this policy will have zero impact on monetary tightness. There is enough, and appropriate, noise about the possibility of asset bubbles, especially after the crisis of last year. If central bank governors do not genuflect to pricking of asset bubbles, they can be accused of not caring for the

poor! There are two kinds of policies which can be used for ex-ante bursting, and in the past, Indian policy makers have followed both i.e. selective, targeted, policy at a sector, and a general across the board increase in interest rates. The latter policy is akin to swatting a fly with a sledge hammer – all that happens is that the glass table shatters, and the fly escapes to the wall. My personal view is that as a rule, policy makers should beware of pricking asset bubbles; but in extreme situations, when the weight of evidence is overwhelming, then targeted policy of the kind used by Subbarao (and also used by Reddy earlier) is appropriate.

*What about inflation?* A significant pointer to the “no raise in rates” policy was contained in RBI’s macroeconomic review released a day earlier. The RBI was at pains to make two valid points: first, that consumer price inflation stayed at elevated levels, and stubbornly so. Second, that most of the inflation that had occurred over the last year was due to food price inflation. Indeed, the gap between WPI manufacturing inflation and overall WPI inflation has been the highest in recent memory. To be sure, central bank governors have to be concerned about inflation; but there is no law of economics that says that monetary policy tightness can address drought induced inflation. So not to attack windmills was another rightful RBI step.

The drought is behind us, and so are elections. The government can now get back to managing the economy rather than managing political campaigns. It is reasonable to expect that food price inflation has run its course; given the slack economy worldwide, it is also reasonable to expect that demand side pressures will take a while to emerge. So the future of inflation looks much better than the past. Given this expectation, a hike in rates to counter inflation and/or to anchor “inflationary expectations” (read I don’t know what causes inflation but the headline number states that it is there!) would have been highly inappropriate, if not downright wrong. Another right RBI step.

The RBI has faced criticism over the years from the single objective advocates. According to these post-modern monetarists, a central bank should only consider a single objective – controlling inflation or “anchoring expectations” presumably whichever comes first! According to these modernists, exchange rate should fluctuate with supply and demand, and growth should be left to take care of itself. The RBI has consistently distanced itself from narrow economics, and Subbarao continues this tradition. Where I differ with RBI is in their forecast of economic growth; only 6 percent they say, while I maintain that we will end fiscal year 2009/10 with a growth rate closer to 8 percent. But this difference does not translate into hiking interest rates because Indian GDP growth would, even at 8 percent, be somewhat lower than the potential growth rate of around 9.5 percent. If so, then don’t look for the repo rate to move much beyond its present level of 4.75 percent, though the reverse repo rate might be expected to close the gap (presently the reverse repo is at 3.25 percent).

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