RBI's peculiar path to policy normalization

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With major central banks around the world ready to call off pandemic-pushed monetary expansions, the Reserve Bank of India (RBI) will now find it increasingly risky to stay behind, lest money fleeing our shores for other markets saddles us with instability. But that does not seem to be playing on RBI's mind for now. On Wednesday, not only did it leave its repo rate unchanged at 4%, it even held its stated reverse repo rate steady at 3.35%. As Omicron has clouded the horizon, it offered no hint either of when it may embark on a policy-reversal path, having eased credit sharply since early-2020 as an economic cushion for covid shocks. This seems odd, given how inflation has flared above projections globally, forcing the US Fed, no less, to gulp back its "transitory" talk and revisit macro risks as the American economy revs up. India's recovery is relatively fragile, but our steep growth incline after last year's blow would still enjoin RBI to raise its price-level vigil, even if inflation has lately stayed within its target range. Our central bank expects it to peak in the last quarter of this fiscal and log "5.3% for 2021-22". Like output growth, pegged at 9.5%, that was an estimate it did not revise. Its inflation forecast for the first half of 2022-23 is 5%. The risk of an unforeseen price flare-up at some point ahead, however, calls for closer attention.

While global commodity prices have cooled lately, especially oil, volatility looks unlikely to reduce and the second-round effects of an earlier fuel upshoot are showing up with their usual lag. Omicron-tightened purses and recent fuel-price cuts could relieve some pressure, as RBI seems to expect, but that could be offset by larger global factors coupled with an upshift in covid-compressed consumer demand amid ample money to go around. Whether seen in the context of capital flows or RBI's domestic commitment to price stability, it risks slipping behind the curve of policy normalization, which would make it harder to catch up later should key variables suddenly go awry. A switch in stance from "accommodative" to "neutral" will likely be required soon, and while Omicron may have stayed its hand, we await clarity on what path it now plans to adopt.

To be fair, it is not as if RBI has overlooked excess money in our financial system. To mop up liquidity, it has conducted 14-day variable reverse repo rate (VRRR) auctions, the average rate of which has been around 3.95%, just a whisker from its repo rate (at which it infuses money) and much above the official reverse repo rate. That RBI intends to conduct ₹6.5 trillion worth of VRRR sales mid-month and then Rs7.5 trillion on New Year's Eve reflects some urgency over short-term monetary conditions. Note that VRRR operations exert influence at the short-tenure end of our bond market's yield curve and are acting as its principal tool for liquidity management as our economy's revival gathers force. Money sucked out of the system at rates of nearly 4% implies a narrowing of its liquidity corridor. This squeeze is consistent with its tightening of the amount that banks can borrow under its marginal standing facility to 2% of their net demand and time liabilities from 3% earlier, though this window has not seen too many borrowers as banks have mostly had surplus funds. While RBI's VRRR approach is too gingerly to quell inflation if its math goes wrong, at least it has begun to clear itself a path for a return to policy normalcy.

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