RBI’s never ending dilemma

(Mains GS 3 :Indian Economy and issues relating to planning, mobilisation of resources, growth, development and employment.)

Context:

- The Union government has recently announced that India’s monetary policy will continue to be guided by the inflation targeting framework for the next five years.
- This decision firmly establishes the mandate of RBI as an inflation-targeting central bank.

The shifting priorities:

- Despite following the policy of Inflation targeting, The RBI’s priorities are not so clear.
- At some points, it seemed to target growth; at others, the exchange rate.
- More recently, it seems to be focusing on yields in the government bond market.
- Consider the RBI’s attempts to control interest rates on government securities (G-secs).
- For some time, the central bank has made it clear to market participants that it would like to keep the 10-year rate around 6 per cent.
- When market participants pressed for higher rates, it repeatedly stepped into the bond markets, purchasing several trillion rupees of G-secs in the second half of 2020-21.
- Most recently, on April 7, it went one step further, announcing a plan to buy Rs 1 trillion worth of government securities in the first quarter of 2021-22.
- For the first time the RBI has committed itself to buying a specific quantum of G-secs over a specified period of time.
- What is distinctive about this Open Market Operation (OMO) plan is its aggressiveness, not only because it is large but also because it is an iron-clad commitment, invariant to future inflation or growth developments.

Possible harm of open market operations:

There are three ways the OMO commitment can go wrong.

Reluctance to purchase bond:

- **RBI** may not succeed in keeping a lid on G-sec rates. It does nothing to address the underlying reasons why bond investors are demanding higher interest rates: A large fiscal deficit leading to massive borrowing by the government in the bond market, and high and rising inflation.
- Market participants may also remain reluctant to purchase bonds at current interest rates.
- They may instead wait until the RBI has purchased its Rs 1 trillion, in the hope that afterwards rates will rise to more remunerative levels.
- By revealing the exact plan in advance, the RBI may have imposed limitations on the success of the programme.

Possible collateral damage:

- Even if the strategy works in containing G-sec yields, this success may create collateral damage.
- In the short run, it could adversely affect interest rates for the private sector.
- If banks find they are not making adequate returns on their (very large) investments in G-secs, they will try to compensate by charging more on credit to the private sector. In this case, the plan would end up hindering the economic recovery.
- There could be further collateral damage over the longer-term.
- One of the key benefits of a bond market is to impose fiscal discipline on governments, by forcing them to pay higher interest rates when government borrowing increases.
- Persistent intervention by the RBI would disrupt this process, increasing the risk that large fiscal deficits will persist.

Jeopardise the inflation targeting:

- Most importantly, the plan may jeopardise the achievement of the inflation target.
- For the past year, the RBI has been injecting copious amounts of liquidity into the banking system, confident that this would not lead to an inflation problem.
- Even when inflation did rise above its central 4 per cent target, it argued that the problem was temporary and would disappear as soon as lockdowns eased and supply returned to normal.

The dilemma faced by RBI:

- The RBI has placed a large bet on the future of the economy.
- If inflation does collapse, then market interest rates will naturally fall, and the conflict between the two objectives will vanish.
- But if inflation remains strong, then the RBI will soon have to choose its priority. Either way there will be a problem.
- If it fails to fulfil its commitment and prematurely ends the liquidity injection, it could lose the confidence of the bond market for a long period of time.

- If, on the other hand, it goes ahead with its OMO plan — injecting Rs 1 trillion despite rising inflation — its credibility as an inflation-targeting central bank will be called into question.

The current scenario:

- An inflation collapse cannot be ruled out. But so far developments are not encouraging.
- Inflation has stubbornly refused to dissipate. It has remained well above the 4 percent target.
- Forward-looking measures such as core inflation remain in the 5-6 per cent range, while fuel and commodity prices have been going up and are likely to firm further as more and more countries recover from the pandemic-triggered crisis.
- In India, several major states are experiencing a resurgence of COVID cases.
- To deal with this new wave, state governments have announced measures that will curb the mobility of goods and people.
- Like last year, these measures will lead to supply chain disruptions which will aggravate the inflationary pressures.
- RBI's attempt to lower the interest rates can also lead to a depreciation of the rupee which may further add fuel to inflation by raising the import bill.

Conclusion:

- If the RBI is too slow to tighten policy and rein in the liquidity it has created, the country could end up facing the kind of inflation crisis that was witnessed in the post-2008 period.
- Thus, India should guard against the possibility that inflation targeting may deliver the worst of all worlds, i.e., raising interest rates, with all negative consequences, without lowering inflation.