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The Economy Observer

Dr Urjit Patel to maintain continuity of monetary policy stance

Appointment helps retain government's credibility to fight against inflation

- **The government has appointed Dr Urjit Patel, RBI's current Deputy Governor, to head the central bank after Dr Raghuram Rajan exits early next month. Dr Patel will be the 24th RBI Governor.**
- **The appointment of Dr Patel, who played an eminent role in creating the monetary framework under which the RBI is operating currently, reinforces government's commitment to continue its fight against inflation. Dr Patel is expected to retain the framework and maintain continuity of India's monetary policy.**
- **Since the monetary policy committee (MPC) will be operational very soon, the Governor's role in determining the policy interest rates will be limited. However, the key will be liquidity management, which is expected to be accommodative.**
- **With Dr Patel taking over India's monetary policy, it now remains to be seen if the fight against inflation continues with the same intensity. It would be important to track the evolution of 14-day repo replacing the weighted call rate as the operative target. We continue to expect a rate cut in December 2016.**

Dr Urjit Patel
24th RBI Governor

- **The appointment reinforces government's commitment to continue its fight against inflation:** By appointing Dr Urjit Patel, currently the Deputy Governor of the RBI and the Chairman of the Expert Committee to revise and strengthen the monetary policy framework, the government has reinforced its commitment to continue its fight against inflation. Yet, it remains to be seen if Dr Patel will continue the anti-inflationary stance with as much intensity.
- **The Governor's role in interest rate policy will be limited:** The Governor's role in setting policy rates would be limited in the future, as the monetary policy committee (MPC) – comprising of six members, three from RBI and three external – would most likely be operative from next monetary policy meeting.
- **However, liquidity management will be of utmost importance:** Nevertheless, liquidity management will play the key role. Here, continuity of the accommodative stance is necessary. Notably, the RBI's recent policy shift to bring the system liquidity deficit towards neutrality directly follows from the Expert Committee report chaired by Dr Patel. *"…Turning to the conduct of liquidity management operations and transmission of policy impulses, there has also been blocked transmission of policy rate cuts to support growth due to the central premise of keeping the system in a deficit mode and the call rate aligned to the repo rate…"*, says the report. With the redemption of FCNR(B) deposits beginning next month, liquidity management will be of utmost importance. With Dr Patel heading the RBI, it may soothe the financial markets.
- **Views of the new Governor on inflation:** With Dr Urjit Patel taking over the RBI, his views on inflation – the nominal policy anchor – become important. Below are three quotes from the recent post-policy conferences.

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General views on inflation: *"…the output gap is still negative by our models and estimates, and if you overlay that with the capacity survey results that we bring out every quarter, which suggests that though capacity utilization has increased, it still remains comfortably below the point where pricing pressure moves in. We have expressed concerns about inflation, excluding food and fuel, which has been sticky and relatively elevated, and we will be watchful that it does not set a lower bound to the disinflation process; however, if you look at the services component of it, there are a couple of good things happening – rural wage pressures which if you think of as a surplus labor set up, from which labor comes to the services sector, the wage increases there remain fairly low…"*

Post policy conference call with Researchers and Analysts – June 7, 2016

Likely impact of 7th Pay Commission on inflation: *"…We are awaiting the details of the implementation of the Seventh Pay Commission Award. Monetary Policy Review that was published in April estimated the impact to be 100-150 basis points over a period of two years which with 100 basis points as the peak direct effect. Target of 5% for Q4 of 2016-17 has to be met. We have said then also that we may look through the first round statistical impact of the HRA effect but we will be watchful for second round and/or effects that are more than transient if they materialize…"*

Post policy conference call with Researchers and Analysts – June 7, 2016

Likely impact of GST implementation on inflation: *"...About 55% of the CPI basket will not be impacted by the GST. Secondly, as the Governor said, the effective rate is going to be important, but remember that one benefit of the GST is that the cascading disappears so you might actually get effective tax rates on many goods and services to come down. And usually as a base expands, you do not need to have a tax rate which is as high as would be required. So the inflationary impact, firstly, it could just be one time; secondly, to the extent that such a large part of the CPI basket is already out of it, I think the durable impact on it is likely to be limited. But it remains to be seen and the full effects of this will be only felt, if at all, possibly in the second half of the next financial year as we go forward..."*

Post policy conference call with Researchers and Analysts – August 9, 2016

- **Tracking the evolution of the monetary policy:** As outlined in the Expert Committee report, the monetary policy will move from Phase-I to Phase-II over time. When the Bank followed the liquidity management framework proposed in the Expert Committee report in April 2016, Dr Urjit Patel stated, "*...The steps that we have undertaken today and the changes that have been made in the liquidity framework are towards the evolution of ensuring that the 14-day repo becomes the operating target. At this point we are still in Phase-I of what the Committee had recommended and the steps taken today were a transition towards the 14-day repo as the operating target...*". The Bank is moving towards the Phase-II of replacing the operative target from weighted call rate to 14-day term repo rate. *Exhibit 1* on the next page gives insights on the evolution of India's monetary policy over the next few years.

Exhibit 1: Proposed operating framework for monetary policy

	Phase-I	Phase-II
Policy Rate to be announced by the MPC	■ Repo rate (overnight).	■ Target policy rate for short end of the money market.
Operating target for monetary policy	■ Weighted average call rate.	■ 14-day term repo rate.
Liquidity management	■ Full accommodation (through a mix of specified amounts of overnight repos at fixed rate, and term repos at variable rate) – ECR to be phased out.	■ Full accommodation (primarily through 14-day term repos at variable rate aimed at achieving the target rate, supported by fine tuning through overnight repos/reverse repos, longer term repos and open market operations). ■ No refinance facility.
MSF – the ceiling of the corridor	■ As a standing facility, this will be available every day. If adequate liquidity is injected through overnight/term repos, use of MSF will be minimal.	■ MSF will set the ceiling of the corridor, but must be seen as a truly penal rate. If the liquidity taken during the fortnight through 14-day term repo is managed effectively, there will be rare need for accessing the MSF.
Reverse repo rate	■ The floor of the corridor – but transition to standing deposit facility will start.	■ Reverse repo will be used in fine tuning operations i.e., to impound only daily surplus liquidity from the system to ensure that money market rates do not drop below the policy target rate. Standing deposit facility will replace reverse repo as the floor of the corridor, and reverse repo rates will be close to the policy rate.
Liquidity assessment	■ By the RBI – based on frictional and structural drivers of liquidity.	■ Daily reporting by banks (aggregated for the system as a whole) will complement the RBI's assessment of liquidity.

Source: RBI's expert committee report to revise and strengthen the monetary policy framework

- **Don't expect a rate cut in October, but most likely in December 2016:** Given our inflation projections, we believe that inflation will be closer to 6% for August as well, which will make it difficult for the RBI (even if MPC is operative) to cut policy rates on October 4, 2016. Nevertheless, with inflation falling towards 5% by the end of 2016 and early 2017, we expect a rate cut of 25 basis points to 6.25% on December 6, 2016. In fact, with the possibility of sub-5% retail inflation in early 2017, there could be another rate cut on February 7, 2017, implying a total cut of 50bp to 6% by the end of FY17.

Overall, the appointment of Dr Urjit Patel to replace Dr Raghuram Rajan at the helm of the RBI helps retain the credibility of the government in its fight against inflation by ensuring continuity of the monetary policy stance.

REPORT GALLERY

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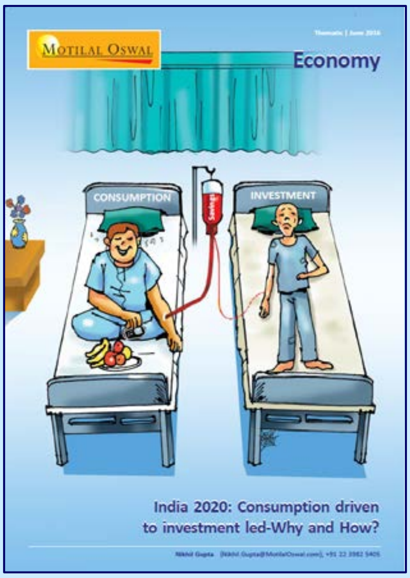

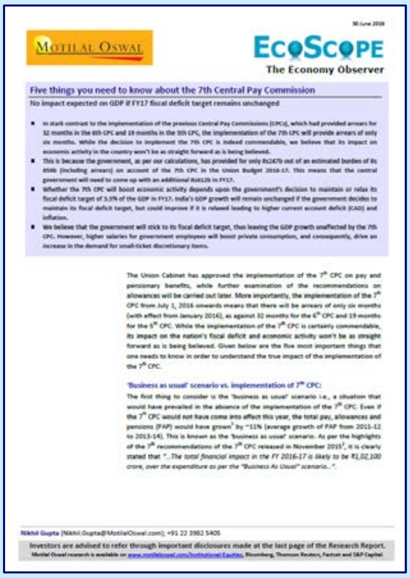

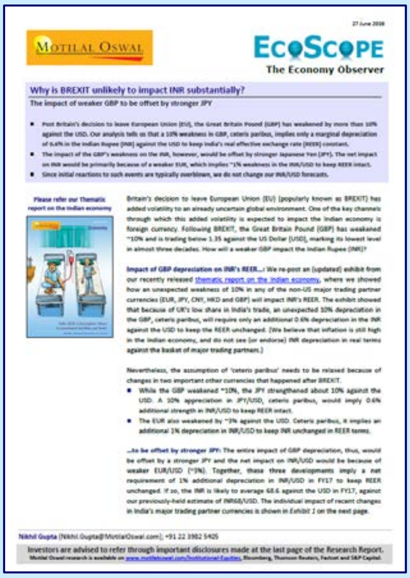

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