Focus back on primary target: inflation at 4%

10-year bond yield climbs 4 basis points

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Mumbai, 8 June

The June monetary policy review marks the Reserve Bank of India's (RBI's) return to 4 per cent inflation target, after a gap of more than three years.

According to law, the RBI has a mandate to keep inflation at 4 per cent, within a band of 2 per cent on either side. Since the onset of the Covid-19 pandemic in March 2020, the central bank's effort has been to stay within the band of 2-6 per cent.

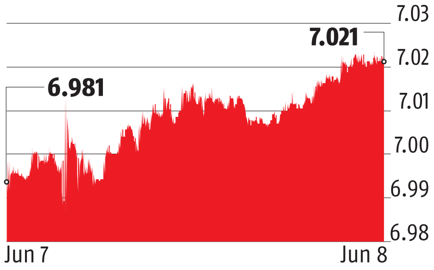
"In India, consumer price inflation eased during March-April 2023 and moved into the tolerance band, declining from 6.7 per cent in 2022-23. Headline inflation, however, is still above the target as per the latest data and is expected to remain so according to our projections for 2023-24," RBI Governor Shaktikanta Das said while announcing the review of the monetary policy.

The six-member monetary policy committee unanimously decided to keep the policy repo rate at 6.5 per cent.

During the post-policy interaction with the media, Das explained that during the Covid pandemic and then the war in Ukraine and its fallout, the central bank decided to keep inflation below the 6 per cent upper limit. However, such uncertainties are no longer there.

DOMINO EFFECT

10-yr G-sec bond yield (in %)



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"Our endeavour is to see that headline inflation aligns with the target on a durable basis. The primary target is 4 per cent. During the stressful times of Covid and thereafter when the Ukraine war broke out and the fall out of war, we operated within the band...we used the flexibility which is available to MPC, so operated within that band. We were tolerant of inflation above 4 per cent and our effort was to keep it below 6 per cent," Das said. "But now the situation has changed. There is greater certainty and the path looks much clearer than it was earlier. Therefore, we are targeting 4 per cent, which is our primary target," he added.

The signal to return to 4 per cent inflation was interpreted as hawkish by the market as reflected in the bond yields which inched up. The yield on the 10-year benchmark government bond went up 4 bps to close the day at 7.02 per cent.

"...the communication, in my opinion, was slightly on the hawkish side with respect to inflation. Even as there was a 10 basis points reduction in the inflation forecast for FY24, the governor was extremely pointed in highlighting that the MPC is now focused on getting inflation down to the 4 per cent central line, rather than being comfortable with the fact that headline inflation is currently within the tolerance band and is likely to remain so for the rest of FY24," said Indranil Pan, Chief Economist, YES Bank.

The central bank has revised the FY24 inflation forecast slightly lower to 5.1 per cent, as compared to 5.2 per cent projected during the April policy review.

One of the downside risks to inflation is monsoon, which has started late, along with the forecast of El Niño. The RBI has projected higher inflation for the second half, with average inflation for the October-December quarter pegged at 5.4 per cent and for January-March at 5.2 per cent.

"Given the uncertainties around the impact of El Niño conditions leading to sub-par monsoon in 2023, the RBI remained cautious and revised the inflation projection by only 10 bps to 5.1 per cent for FY24. The RBI governor stressed on moving towards the primary target of 4 per cent inflation," said Dhiraj Relli, managing director and chief executive officer, HDFC Securities.

"In this backdrop, expectation of a rate cut in this calendar year seems to have faded. We expect the first rate cut perhaps in February 2024," Relli said.