● Q1FY25 GDP GROWTH SEEN AT 7.4%

Prudent to stay the course on 4% CPI target: RBI paper

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DISINFLATION HAS BEEN "grudging and uneven" so far, and the headline CPI inflation remains closer to 5% against the target of 4%, despite "historically low" readings on core inflation and "sustained deflation" in fuel prices, wrote the Reserve Bank of India (RBI) staff.

Given the high uncertainty shrouding the outlook, it is "prudent to eschew the temptation of time inconsistency and stay the course on the straight and narrow path of aligning inflation with the target of 4%", the staff opined in a paper titled 'State of the Economy', included in the central bank's bulletin for July.

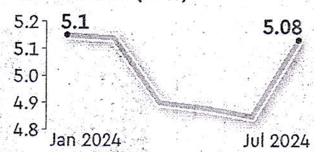
On growth, the paper said the RBI's economic activity index (EAI) has projected the country's GDP to grow at 7.4% in the first quarter of FY25, in the backdrop of "robust domestic demand conditions".

The paper said the available data of high-frequency indicators reflect resilience of economic activity in Q1FY25. However, the latest projection of Q1 growth is 10 bps lower than the projection made in May.

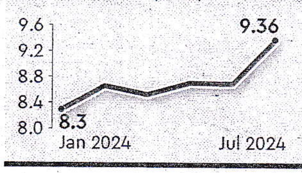
The authors, meanwhile, mentioned that they don't imply that inflation should reach 4% and stay there before monetary policy considers a change in stance; instead, based on a careful evaluation of the balance of risks, an enduring movement towards the target should provide "signals to forward-looking monetary policy to respond".

PRICE PRESSURES

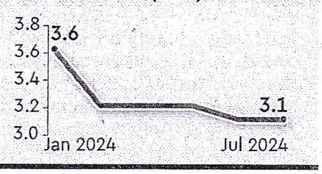
CPI inflation (in %)



Food inflation (in %)



Core inflation (in %)



Currently, the repo rate stands at 6.5%, unchanged since February 2023; but in the June meeting two of the six members of the RBI's Monetary Policy Committee asked for a reduction in the rate by at least 25 bps, as they feel the economy is slowly inching towards a real interest of 2%, which may be detrimental to growth.

The paper mentioned that the argument that food price shocks are "transitory" does not seem to be borne out by the actual experience over the past one year — "too long a period for a shock to be termed as transitory!" it said.

Superimposed on this 'persistent' component are sporadic spikes in prices of a range of vegetables that overlap across constituents to give the broader category of vegetables inflation an "enduring character", the paper noted.

In June, food inflation stood at a six-month high of 9.36%, mainly due to a sharp rise in prices of key vegetables — onion and potato. Both the vegetables recorded an inflation rate of 58.49% and 57.59%, respectively, in June.

Analysts say their prices are expected to stay elevated at least till August. As a result, most economists now expect CPI inflation in Q2 to average 40-50 basis points higher than the RBI's estimate of 3.8% for the quarter.

"Food prices are clearly dominating the behaviour of headline inflation and households' inflation expectations, undermining the gains of lowering core and fuel inflation through a combination of monetary policy and supply management," the paper said.

While households' current perception of inflation has been moderating, this is not being reflected in their three months ahead and one year ahead expectations which remain elevated.

"The accumulation of food price pressures threatens the outlook for inflation in the form of spillovers to wages, rents and expectations," said the paper.

Against this background, the MPC of the RBI has committed to align inflation durably to the target. "Till that is achieved, the recent halting declines in inflation readings have to be regarded as work still in progress," the paper noted.

The authors warned that "when monetary policy authorities committing to price stability renege on that commitment in the pursuit of short-run gains of increasing growth, they can end up losing credibility, unhinging inflation expectations and triggering a surge in inflation. This can also undermine growth sustainability".

In an interview with *FE*, an external member of the MPC Shashanka Bhide had said that while deciding the policy, "we should take into account the inflation target so that fluctuations in inflation rate do not lead to more difficult inflation-growth trade-off".

"At this point, we are looking at inflation moving to the target and a durable moderate inflation is necessary for supporting demand," he had said.