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October 18, 2017

Minutes of the Monetary Policy Committee Meeting
October 3-4, 2017
[Under Section 45ZL of the Reserve Bank of India Act, 1934]

The seventh meeting of the Monetary Policy Committee (MPC), constituted under section 45ZB of the amended Reserve Bank of India Act, 1934, was held on October 3 and 4, 2017 at the Reserve Bank of India, Mumbai.

2. The meeting was attended by all the members - Dr. Chetan Ghate, Professor, Indian Statistical Institute; Dr. Pami Dua, Director, Delhi School of Economics; Dr. Ravindra H. Dholakia, Professor, Indian Institute of Management, Ahmedabad; Dr. Michael Debabrata Patra, Executive Director (the officer of the Reserve Bank nominated by the Central Board under Section 45ZB(2)(c) of the Reserve Bank of India Act, 1934); Dr. Viral V. Acharya, Deputy Governor in charge of monetary policy - and was chaired by Dr. Urjit R. Patel, Governor.

3. According to Section 45ZL of the amended Reserve Bank of India Act, 1934, the Reserve Bank shall publish, on the fourteenth day after every meeting of the Monetary Policy Committee, the minutes of the proceedings of the meeting which shall include the following, namely:–

(a) the resolution adopted at the meeting of the Monetary Policy Committee;
(b) the vote of each member of the Monetary Policy Committee, ascribed to such member, on the resolution adopted in the said meeting; and
(c) the statement of each member of the Monetary Policy Committee under sub-section (11) of section 45ZI on the resolution adopted in the said meeting.

4. The MPC reviewed the surveys conducted by the Reserve Bank to gauge consumer confidence, households' inflation expectations, corporate sector performance, credit conditions, the outlook for the industrial, services and infrastructure sectors, and the projections of professional forecasters. The MPC also reviewed in detail staff's macroeconomic projections, and alternative scenarios around various risks to the outlook. Drawing on the above and after extensive discussions on the stance of monetary policy, the MPC adopted the resolution that is set out below.

Resolution

5. On the basis of an assessment of the current and evolving macroeconomic situation at its meeting today, the Monetary Policy Committee (MPC) decided to:

- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.0 per cent.

Consequently, the reverse repo rate under the LAF remains at 5.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 6.25 per cent.

The decision of the MPC is consistent with a neutral stance of monetary policy in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth. The main considerations underlying the decision are set out in the statement below.

Assessment

6. Since the MPC's meeting in August 2017, global economic activity has strengthened further and become broad-based. Among advanced economies (AEs), the US has continued to expand with revised Q2 GDP growing at its strongest pace in more than two years, supported by robust consumer spending and business fixed investment. Recent hurricanes could, however, weigh on economic activity in the near-term. In the Euro area, the economic recovery gained further traction and spread, underpinned by domestic demand. While private consumption benefited from employment gains, investment rose on the back of favourable financing conditions. The Euro area purchasing managers' index (PMI) for manufacturing soared to its highest reading in more than six years. The Japanese economy continued on a path of healthy expansion despite a downward revision in growth since March 2017 on weaker than expected capital expenditure.

7. Among the major emerging market economies (EMEs), strong growth in Q2 in China was powered by retail sales, and imports grew at a rapid pace, suggesting robust domestic demand; investment activity, however, slowed down. The Brazilian economy expanded for two consecutive quarters in Q2 on improving terms of trade, even as the impact of recession persists on the labour market. Economic activity in Russia recovered further, supported by strengthening global demand, firming up of oil prices and accommodative monetary policy. Although South Africa has emerged out of recession in Q2, the economy faces economic and political challenges.

8. The latest assessment by the World Trade Organisation (WTO) indicates a significant improvement in global trade in 2017 over the lacklustre growth in 2016, backed by a resurgence of Asian trade flows and rising imports by North America. Crude oil prices hit a two-year high in September on account of the combined effect of a pick-up in demand, tightening supplies due to production cuts by the Organisation of the Petroleum Exporting Countries (OPEC) and declining crude oil inventories in the US. Metal prices have eased since mid-September on weaker than expected Chinese industrial production data. Bullion prices touched a year's high in early September on account of safe-haven demand due to geo-political tensions, before weakening somewhat in the second half. Weak non-oil commodity prices and low wage growth kept inflation pressures low in most AEs and subdued in several EMEs, largely reflecting country-specific factors.

9. Global financial markets have been driven mainly by the changing course of monetary policy in AEs, generally improving economic prospects and oscillating geo-political factors. Equity markets in most AEs have continued to rise. In EMEs, equities generally gained on improved global risk appetite, supported by upbeat economic data and expectations of a slower pace of monetary tightening in major AEs. While bond yields in major AEs moved sideways, they showed wider variation in EMEs. In currency markets, the US dollar weakened further and fell to a multi-month low in September on weak inflation, though it recovered some lost ground in the last week of September on a hawkish US Fed stance and tensions around North Korea. The

euro surged to a two and a half year high against the US dollar towards end-August on positive economic data, whereas the Japanese yen experienced sporadic bouts of volatility triggered by geo-political risks. Emerging market currencies showed divergent movements and remained highly sensitive to monetary policies of key AEs. Capital flows to EMEs have continued, but appear increasingly vulnerable to the normalisation of monetary policy by the US Fed.

10. On the domestic front, real gross value added (GVA) growth slowed significantly in Q1 of 2017-18, cushioned partly by the extensive front-loading of expenditure by the central government. GVA growth in agriculture and allied activities slackened quarter-on-quarter in the usual first quarter moderation, partly reflecting deceleration in the growth of livestock products, forestry and fisheries. Industrial sector GVA growth fell sequentially as well as on a y-o-y basis. The manufacturing sector – the dominant component of industrial GVA – grew by 1.2 per cent, the lowest in the last 20 quarters. The mining sector, which showed signs of improvement in the second half of 2016-17, entered into contraction mode again in Q1 of 2017-18, on account of a decline in coal production and subdued crude oil production. Services sector performance, however, improved markedly, supported mainly by trade, hotels, transport and communication, which bounced back after a persistent slowdown throughout 2016-17. Construction picked up pace after contracting in Q4 of 2016-17. Financial, real estate and professional services turned around from their lacklustre performance in the second half of 2016-17. Of the constituents of aggregate demand, growth in private consumption expenditure was at a six-quarter low in Q1 of 2017-18. Gross fixed capital formation exhibited a modest recovery in Q1 in contrast to a contraction in the preceding quarter.

11. Turning to Q2, the south-west monsoon, which arrived early and progressed well till the first week of July, lost momentum from mid-July to August – the crucial period for *kharif* sowing. By end-September, the cumulative rainfall was deficient by around 5 per cent relative to the long period average, with 17 per cent of the geographical area of the country receiving deficient rainfall. The live storage in reservoirs fell to 66 per cent of the full capacity as compared with 74 per cent a year ago. The uneven spatial distribution of the monsoon was reflected in the first advance estimates of *kharif* production by the Ministry of Agriculture, which were below the level of the previous year due to lower area sown under major crops including rice, coarse cereals, pulses, oilseeds, jute and mesta.

12. The index of industrial production (IIP) recovered marginally in July 2017 from the contraction in June on the back of a recovery in mining, quarrying and electricity generation. However, manufacturing remained weak. In terms of the use-based classification, contraction in capital goods, intermediate goods and consumer durables pulled down overall IIP growth. In August, however, the output of core industries posted robust growth on the back of an uptick in coal production and electricity generation. The manufacturing PMI moved into expansion zone in August and September 2017 on the strength of new orders.

13. On the services side, the picture remained mixed. Many indicators pointed to improved performance even as the services PMI continued in the contraction zone in August due to low new orders. In the construction segment, steel consumption was robust. In the transportation sector, sales of commercial and passenger vehicles as well as two and three-wheelers, railway freight traffic and international air passenger traffic showed significant upticks. However, cement production, cargo handled at major ports, domestic air freight and passenger traffic showed weak performance.

14. Retail inflation measured by year-on-year change in the consumer price index (CPI) edged up sequentially in July and August to reach a five month high, due entirely to a sharp pick up in momentum as the favourable base effect tapered off in July and disappeared in August. After a decline in prices in June, food inflation rebounded in the following two months, driven mainly by a sharp rise in vegetable prices, along with the rise in inflation in prepared meals and fruits. Cereals inflation remained benign, while deflation in pulses continued for the ninth successive month. Fuel group inflation remained broadly unchanged in August even as inflation in liquefied petroleum gas (LPG), kerosene, firewood and chips rose. Petroleum product prices tracked the hardening of international crude oil prices.

15. CPI inflation excluding food and fuel also increased sharply in July and further in August, reversing from its trough in June 2017. The increase was broad-based in both goods and services. Housing inflation hardened further in August on account of higher house rent allowances for central government employees under the 7th central pay commission award. Inflation in household goods and services in health, recreation and clothing & footwear sub-groups increased. Quantitative inflation expectations of households eased in the September 2017 round of the Reserve Bank's survey. However, in terms of qualitative responses, the proportion of respondents expecting the general price level to increase by more than the current rate rose markedly for the three-month as well as one-year ahead horizons. Farm and industry input costs picked up in August. Real wages in the rural and organised sectors continued to edge up. The Reserve Bank's industrial outlook survey showed that corporate pricing power for the manufacturing sector remained weak. In contrast, firms polled for the services sector PMI reported a sharp rise in prices charged.

16. Surplus liquidity in the system persisted through Q2 even as the build-up in government cash balances since mid-September 2017 due to advance tax outflows reduced the size of the surplus liquidity significantly in the second half of the month. Currency in circulation increased at a moderate pace during Q2, by ₹ 569 billion as against ₹ 1,964 billion during Q1, reflecting the usual seasonality. Consistent with the guidance given in April 2017 on liquidity, the Reserve Bank conducted open market sales operations on six occasions during Q2 to absorb ₹ 600 billion of surplus liquidity on a durable basis, in addition to the issuances of treasury bills (of tenors ranging from 312 days to 329 days) under the market stabilisation scheme (MSS) during April and May of ₹ 1 trillion. As a result, net average absorption of liquidity under the LAF declined from ₹ 3 trillion in July to ₹ 1.6 trillion in the second half of September. The weighted average call rate (WACR), which on an average, traded below the repo rate by 18 basis points (bps) during July, firmed up by 5 bps in September on account of higher demand for liquidity around mid-September in response to advance tax outflows.

17. Reflecting improving global demand, merchandise export growth picked up in August 2017 after decelerating in the preceding three months. Engineering goods, petroleum products and chemicals were the major contributors to export growth in August 2017; growth in exports of readymade garments and drugs & pharmaceuticals too returned to positive territory. However, India's export growth continued to be lower than that of other emerging economies such as Brazil, Indonesia, South Korea, Turkey and Vietnam, some of which have benefited from the global commodity price rebound. Import growth remained in double-digits for the eighth successive month in August and was fairly broad-based. While the surge in imports of crude oil and coal largely reflected a rise in international prices, imports of machinery, machine tools, iron and steel also picked up. Gold import volume has declined sequentially since June 2017, though the level in August was more than twice that of a year ago. The sharper increase in imports relative to exports resulted

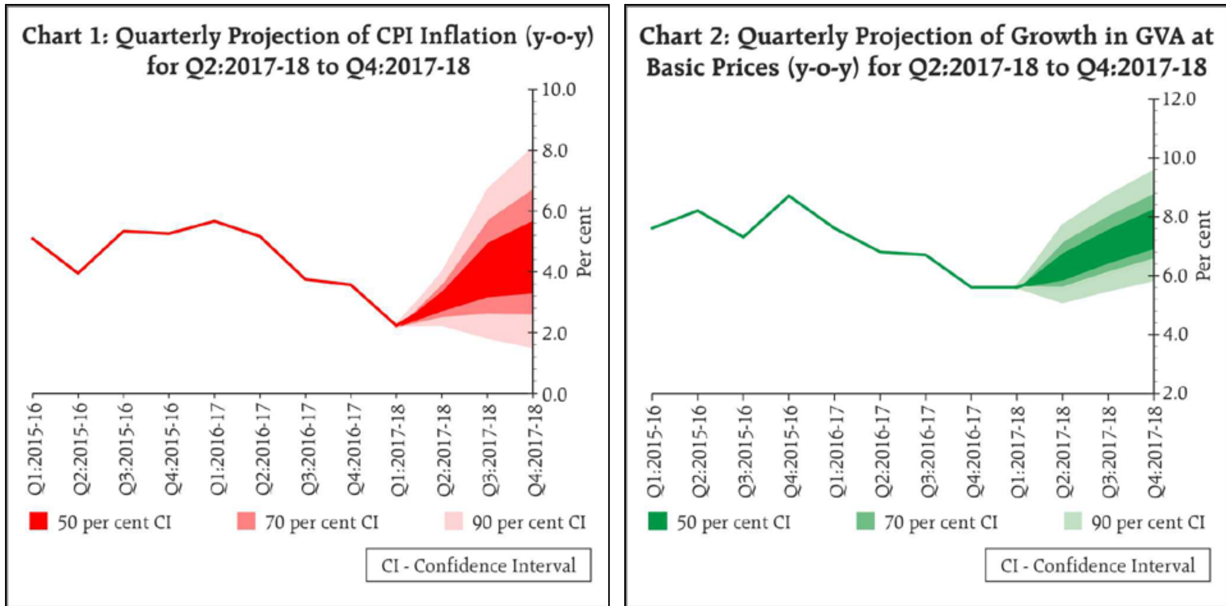
in a widening of the current account deficit in Q1 of 2017-18, even as net services exports and remittances picked up. Net foreign direct investment at US$ 10.6 billion in April-July 2017 was 24 per cent higher than during the same period of last year. While the debt segment of the domestic capital market attracted foreign portfolio investment of US$ 14.4 billion, there were significant outflows in the equity segment in August-September on account of geo-political uncertainties and expected normalisation of Fed asset purchases. India's foreign exchange reserves were at US$ 399.7 billion on September 29, 2017.

Outlook

18. In August, headline inflation was projected at 3 per cent in Q2 and 4.0-4.5 per cent in the second half of 2017-18. Actual inflation outcomes so far have been broadly in line with projections, though the extent of the rise in inflation excluding food and fuel has been somewhat higher than expected. The inflation path for the rest of 2017-18 is expected to be shaped by several factors. First, the assessment of food prices going forward is largely favourable, though the first advance estimates of *kharif* production pose some uncertainty. Early indicators show that prices of pulses which had declined significantly to undershoot trend levels in recent months, have now begun to stabilise. Second, some price revisions pending the goods and services tax (GST) implementation have been taking place. Third, there has been a broad-based increase in CPI inflation excluding food and fuel. Finally, international crude prices, which had started rising from early July, have firmed up further in September. Taking into account these factors, inflation is expected to rise from its current level and range between 4.2-4.6 per cent in the second half of this year, including the house rent allowance by the Centre (Chart 1).

19. As noted in the August policy, there are factors that continue to impart upside risks to this baseline inflation trajectory: (a) implementation of farm loan waivers by States may result in possible fiscal slippages and undermine the quality of public spending, thereby exerting pressure on prices; and (b) States' implementation of the salary and allowances award is not yet considered in the baseline projection; an increase by States similar to that by the Centre could push up headline inflation by about 100 basis points above the baseline over 18-24 months, a statistical effect that could have potential second round effects. However, adequate food stocks and effective supply management by the Government may keep food inflation more benign than assumed in the baseline.

20. Turning to growth projections, the loss of momentum in Q1 of 2017-18 and the first advance estimates of *kharif* foodgrains production are early setbacks that impart a downside to the outlook. The implementation of the GST so far also appears to have had an adverse impact, rendering prospects for the manufacturing sector uncertain in the short term. This may further delay the revival of investment activity, which is already hampered by stressed balance sheets of banks and corporates. Consumer confidence and overall business assessment of the manufacturing and services sectors surveyed by the Reserve Bank weakened in Q2 of 2017-18; on the positive side, firms expect a significant improvement in business sentiment in Q3. Taking into account the above factors, the projection of real GVA growth for 2017-18 has been revised down to 6.7 per cent from the August 2017 projection of 7.3 per cent, with risks evenly balanced (Chart 2).



21. Imparting an upside to this baseline, household consumption demand may get a boost from upward salary and allowances revisions by states. Teething problems linked to the GST and bandwidth constraints may get resolved relatively soon, allowing growth to accelerate in H2. On the downside, a faster than expected rise in input costs and lack of pricing power may put further pressure on corporate margins, affecting value added by industry. Moreover, consumer confidence of households polled in the Reserve Bank's survey has weakened in terms of the outlook on employment, income, prices faced and spending incurred.

22. The MPC observed that CPI inflation has risen by around two percentage points since its last meeting. These price pressures have coincided with an escalation of global geo-political uncertainty and heightened volatility in financial markets due to the US Fed's plans of balance sheet unwinding and the risk of normalisation by the European Central Bank. Such juxtaposition of risks to inflation needs to be carefully managed. Although the domestic food price outlook remains largely stable, generalised momentum is building in prices of items excluding food, especially emanating from crude oil. The possibility of fiscal slippages may add to this momentum in the future. The MPC also acknowledged the likelihood of the output gap widening, but requires more data to better ascertain the transient versus sustained headwinds in the recent growth prints. Accordingly, the MPC decided to keep the policy rate unchanged. The MPC also decided to keep the policy stance neutral and monitor incoming data closely. The MPC remains committed to keeping headline inflation close to 4 per cent on a durable basis.

23. The MPC was of the view that various structural reforms introduced in the recent period will likely be growth augmenting over the medium- to long-term by improving the business environment, enhancing transparency and increasing formalisation of the economy. The Reserve Bank continues to work towards the resolution of stressed corporate exposures in bank balance sheets which should start yielding dividends for the economy over the medium term.

24. The MPC reiterated that it is imperative to reinvigorate investment activity which, in turn, would revive the demand for bank credit by industry as existing capacities get utilised and the requirements of new capacity open up to be financed. Recapitalising public sector banks adequately will ensure that credit flows to the productive sectors are not impeded and growth impulses not restrained. In addition, the following measures could be undertaken to support growth and achieve a faster

closure of the output gap: a concerted drive to close the severe infrastructure gap; restarting stalled investment projects, particularly in the public sector; enhancing ease of doing business, including by further simplification of the GST; and ensuring faster rollout of the affordable housing program with time-bound single-window clearances and rationalisation of excessively high stamp duties by states.

25. Dr. Chetan Ghate, Dr. Pami Dua, Dr. Michael Debabrata Patra, Dr. Viral V. Acharya and Dr. Urjit R. Patel were in favour of the monetary policy decision, while Dr. Ravindra H. Dholakia voted for a policy rate reduction of at least 25 basis points. The minutes of the MPC's meeting will be published by October 18, 2017.

26. The next meeting of the MPC is scheduled on December 5 and 6, 2017.

Voting on the Resolution to keep the policy repo rate unchanged at 6.0 per cent

Member	Vote
Dr. Chetan Ghate	Yes
Dr. Pami Dua	Yes
Dr. Ravindra H. Dholakia	No
Dr. Michael Debabrata Patra	Yes
Dr. Viral V. Acharya	Yes
Dr. Urjit R. Patel	Yes

Statement by Dr. Chetan Ghate

27. In the August review, I was concerned that the downward movement in both CPI headline inflation and inflation excluding food and fuel may not sustain into the durable future. With a roughly 200 basis points increase in headline inflation in the last two months, and with the acceleration of inflation excluding food and fuel to 4.6 per cent from 4.1 per cent, upside risks to the medium term inflation target of 4 per cent have again come to the fore. This suggests that the big dip in inflation excluding food and fuel starting in March has turned out to be temporary.

28. The rebound in headline inflation has largely been due to spikes in vegetable inflation that has made the CPI vegetable index come back to its earlier peak. I am also concerned about adverse demand-supply dynamics in crude prices which had led to a 22 per cent increase in crude prices since June 2017. A relaxation of end-year fiscal deficit targets if tax revenues take a hit due to GST-related disruptions also poses an upside risk to the medium term inflation target. On the other hand, I view the recent round of inflationary expectations data as positive, with the decline in the 3-month inflationary expectations being about 230 basis points since September 2016.

29. While there has been a secular decline in economic growth for the past 6 quarters, it is likely that the Q1:2017-18 GVA growth print of 5.6 per cent was possibly a trough, and that a revival in economic activity is possibly in the works. The economy has been subject to numerous policy shocks in the form of the Insolvency and Bankruptcy Code (IBC), GST, Real Estate (Regulation and Development) Act (RERA), loan waivers, and demonetisation, all of which have undoubtedly lead to some churning, but which will also move the economy to a reformed steady state. What makes me optimistic are the following factors: (i) both the August and September PMI in manufacturing have been in an expansion mode. (ii) An economic revival of the Eurozone will push up exports. (iii) Real wage growth of the magnitude

of 6-8 per cent in the rural sector will continue to support consumption driven growth. Having said this, I continue to worry about the slowing rate of capital accumulation and its impact on lowering potential growth and total factor productivity (TFP), but would like to see the next GDP growth print to have a better sense of whether the current decline in growth is transient, or part of a secular trend.

30. In some joint research done by myself and some co-authors, on a calibrated/estimated dynamic stochastic general equilibrium (DSGE) model of the Indian economy, the variance decomposition from the baseline model shows that about half of the fluctuations (variance) in output in the Indian economy in the last five years are explained by TFP shocks, and one-third is explained by fiscal shocks. Monetary policy shocks only explain around 12 per cent of output variations. This highlights not only the weakness of monetary policy transmission in the Indian economy, but the need for continual structural reforms and rule bound fiscal policy which will stabilize the Indian business cycle.

31. Taking into account these considerations, I vote for a pause in the policy repo rate at today's meeting of the Monetary Policy Committee.

Statement by Dr. Pami Dua

32. On the inflation front, retail inflation recorded a five-month high in August, 2017. This was driven partly by the dissipation of the favourable base effect and a rebound in food inflation, due to an increase in vegetable prices. CPI inflation, excluding food and fuel, rose sharply as a result of hardening of prices in several categories. Housing inflation increased on account of higher house rent allowances for central government employees under the 7th central pay commission award. Other sub-groups witnessing an increase included household goods and services, clothing, footwear, and miscellaneous items.

33. Brent crude oil prices also surged in September, while the rupee weakened. Other upside risks to inflation include the impact of an expected decline in the production of foodgrains due to lower sowing during the *kharif* season; the uncertainty in the short-term with respect to the effect of GST; the effects of a possible central government stimulus; the likely fiscal slippages due to the farm loan waivers; and the introduction of the pay commission award by states. Further, a potential increase in financial market volatility due to global developments, including the unwinding of the balance sheet by the Fed and the possibility of normalisation by the ECB, are also major concerns.

34. These risks to inflation are reinforced by the responses to forward-looking surveys of consumers. Specifically, the qualitative responses to the September 2017 round of the Reserve Bank's Inflation Expectations Survey of households indicate that the proportion of respondents expecting the general price level to increase by more than the current rate rose over the three-month as well as the one-year horizons. The September round of the Consumer Confidence Survey also signals the expectation of an increase in the price level in the next one year. Moreover, an uptick in the Indian Future Inflation Gauge, a harbinger of inflation (constructed by the Economic Cycle Research Institute (ECRI), New York, with which the author is affiliated), indicates a firming in underlying inflationary pressures.

35. On the output front, GDP growth slowed down significantly in the first quarter of 2017-18, reflecting slower agricultural and manufacturing growth, along with tepid consumption and investment demand. Growth in services sector, however, picked up with an uptick in trade, hotels, transport and communication. The lacklustre growth is picked up by the September round of the Reserve Bank's Consumer Confidence

Survey, which shows a fall in the Current Situation Index as well as the Future Expectations Index, due to worsening sentiment on income and employment. Furthermore, growth in ECRI's Indian Leading Index, a predictor of future economic activity, has eased in recent months. This suggests an urgent need to revive investment activity and reinvigorate infrastructure-related projects, amongst other measures.

36. At the same time, growth in ECRI's Indian Leading Exports Index, that anticipates the direction of growth in exports, is declining. It is also notable in this context that, while international growth is currently robust, ECRI's Leading Indexes of the global economy indicate waning global growth prospects.

37. In the current scenario, a wait and watch strategy is recommended with continuous monitoring of data to distinguish between a temporary effect and a long-lasting, structural impact.

38. Thus, I vote for keeping the policy repo rate unchanged.

Statement by Dr. Ravindra H. Dholakia

39. During the last two months of July and August, the increase in the headline inflation as well as inflation without food and fuel was more than expected. My forecasts had provided for some spikes in inflation during these months, but the actual increase exceeded the forecasts. While the oil prices strengthened in the international markets, they are not expected to increase further substantially. Although the monsoon ended with a marginal shortfall in the rainfall, its impact on the food prices is not expected to be very adverse since the replenished buffer stocks would take care of whatever shortages occur. The real cause of concern right now is the estimates of real GDP during Q1 of 2017-18 that showed a significantly more than expected slowdown of economic activity indicating widening of the negative output gap in the economy. Considering these additional developments, I strongly plead for at least a 25 basis points (bps) cut in the policy rate. Reasons for my vote are the following:

i) Households' one year ahead inflationary expectations according to the RBI survey have fallen over the last year sharply by 340 bps when the policy rate fell by only 50 bps. This implies a significant increase of 290 bps in the real interest rate for the households.

ii) The Indian Institute of Management Ahmedabad (IIMA) Business Inflation Expectation Survey (BIES) shows that the businesses expect inflation one year ahead to be around 3.5 per cent in their costs. This inflation number is generally closely akin to the core inflation.

iii) RBI survey has found that companies have started investing in financial assets rather than fixed assets. It indicates that the real interest cost on one hand and real interest rate on the other hand perceived by the companies are too high. This is supported by the decline in the new projects announced.

iv) My inflation forecasts over six months and one year have only marginally changed upwards since I expect oil prices and exchange rates to be reasonably stable over medium term. Moreover, we had considered earlier such scenarios in our forecasts. Even RBI's forecast of inflation has not changed substantially and is around 4.3 per cent without the impact of revisions in house rent allowance. As I had mentioned in the August MPC minutes, our forecast is lower. In this context, it is worth observing that the

headline inflation without including housing index is currently only around 3 per cent.

v) RBI surveys continue to show persistently low capacity utilization at around 71-72 per cent indicating a sizeable negative output gap in the production sector. This is also supported by RBI consumer confidence surveys showing worsening sentiments for income, employment and overall environment. RBI has also revised its GVA growth forecast downward in its October Bi-monthly Monetary Policy Review for 2017-18 by 60 bps and for 2018-19 by 70 bps in its October Monetary Policy Report (MPR) compared to its April 2017 MPR. This by itself suggests that the negative output gap in the economy has widened at present and would continue widening in near future since output gap is calculated on levels and not rates of growth, which implies that the negative output gap would start narrowing only when the current growth rate exceeds the potential rate of growth.

vi) There are some sceptics who argue that in India, where physical infrastructure like roads and railways are over-crowded, a negative output gap simply cannot exist. However, this argument is not valid since it is based on misconception of the potential output. Congestion and overcrowding of certain type of physical infrastructure that could be due to wrong pricing and other policies usually lead to very low productivity and indicate sub-optimal allocation of resources. This corroborates rather than negating the existence of a negative output gap, because the potential output is defined in terms of the optimal utilization of resources and not the actual utilization of resources. For instance, previously congested and hence inefficient roads have turned more efficient with introduction of Goods and Services Tax (GST). The existing capital is better utilized and produces more output. Moreover, we need to recognize that many other physical infrastructures like some airports, seaports, irrigation dams, hospitals, institutions of higher learning and several industrial plants and machinery lie severely underutilized. Similarly a significant proportion of the labour force is underutilized. Therefore, negative output gap and its widening at present as argued earlier cannot be denied.

vii) A rule-based monetary policy underlying the Flexible Inflation Targeting framework would necessitate a very well justified policy rate cut under the present circumstances. Real interest rate with expected future inflation rate in the economy currently is too high compared to most other countries. Now it has started seriously hurting consumers of durable goods and producers and hence production. We also need to recognize explicitly the cost of sacrificing output growth in terms of unemployment and poverty when inflation situation is practically under control in the near to medium term. In order to address the problems created by expanding negative output gap, we need to bring down the real interest rate in the economy. In my view, the policy rate should have been cut by 50 bps long back in June 2017. A cut of 25 bps in August was too small and too late. We can still make the additional cut of 25 bps now if we want to be extremely cautious. Otherwise, my opinion is that we have a space for a cut of about 40 bps at present with due consideration to any possible upward risk to future inflation.

Statement by Dr. Michael Debabrata Patra

40. Recent inflation prints have vindicated my stance. They have also borne out the expectations of households and professional forecasters. All the factors I cited came into play in the inflation reading for August - the house rent allowance (HRA)

for Central Government employees; the GST; the unfavourable reversal of base effects; and the seasonal spike in the prices of vegetables. Some of these factors will gain further traction over the months ahead. The firming up of pump prices of petrol and diesel, only partly due to rising international crude prices, has provided an additional upside to the inflation outlook in a froth-suffused financial environment. The recent reduction in excise duties on petroleum products is an acknowledgement of the social tolerance threshold for inflation from this source.

41. By contrast, all the factors conditioning the August rate reduction have either not materialized or reversed - inflation excluding the HRA will likely exceed 4 per cent by the end of the year; inflation excluding food and fuel has turned up and will likely stay above 4 per cent in the months ahead; the rollout of the GST has not been smooth; and the monsoon is sub-normal in terms of its distribution during the crucial sowing weeks. With various alternative exclusion-based indicators of inflation above 4 per cent, a vicious spiral could be developing – input costs; petroleum product prices, exchange rate depreciation; inflation expectations. Professional forecasters project inflation rising to 5 per cent by the first quarter of 2018-19. Households' qualitative expectations point to the rising probability of inflation rising faster than the current rate over the next three months.

42. Current inflation developments and, in particular, deviations of outcomes from forecasts are shaping the future path of inflation in an ongoing error correction. The primary objective of monetary policy enjoined by the RBI Act is challenged and the credibility of the MPC will be tested in the months ahead.

43. Meanwhile, growth outcomes have surprised on the downside. Parsing the data reveals that agricultural and allied activities are growing at broadly the same pace as in the first quarter of every year, while in the services sector, growth has accelerated. More recent indicators bear out these initial impulses. My sense is that the slowdown is troughing and activity will pick up in the second half of the year with better prospects for agriculture and services, and as the initial hitches associated with the GST get evened out.

44. The slowdown is essentially located in manufacturing, and reinvigorating it holds the key. The question is: is the weakness in manufacturing, which persists in spite of a reduction of 200 basis points in the policy rate, within the narrow remit of monetary policy? The advocacy for a further reduction in the policy rate is essentially a case for lowering the cost of capital or the hurdle rate to a level at which a subdued or even declining internal rate of return (IRR) becomes viable. In my view, this is not a sustainable proposition and may even be self-fulfilling: chasing a deteriorating IRR will only lead to higher inflation and no investment.

45. All indications point to a deeper malaise that chains down animal spirits in private enterprise and cries out for a bold structural transformation of the business and investment climate. The MPC's resolution sets out the elements of the desired policy response that will revive investment activity. A monetary policy reaction in the absence of mobilising on these fronts is time-inconsistent – the MPC commits to an inflation target over a medium term horizon but the persuasive pull of the transient weakening of growth in the interregnum potentially undermines this commitment.

46. I, therefore, vote for status quo, but only as long as inflation readings stay within the target of 4 per cent. It is time to be in readiness to raise the policy rate to quell the underlying drivers of inflation if they strengthen further.

Statement by Dr. Viral V. Acharya

47. Over the past few years, household inflation expectations have been steadily getting anchored down as they are adapting to the realised inflation outcomes. However, these expectations still remain relatively high, and are likely also manifested in the continuing high level of rural and non-rural wage growth. Recent headline inflation prints have risen significantly from historic low in June and in a broad-based manner; in addition, oil-price risk and global market volatility have risen materially. In such a scenario, it is important in my view for the Reserve Bank to persist steadfastly with its objective (and mandate) of keeping medium-term inflation within a striking distance of the target of 4 per cent.

48. Real-time activity indicators have been volatile over the last two quarters and do not yet paint a clear picture. Hence, it is too early, in my view, to be able to isolate the transient component of the recent one-quarter loss of momentum over and above the gradual decline in overall growth that has taken place since the Q1 of 2016-17. The gradual decline, which has turned our measures of output gap negative, is best explained by the deleveraging underway in the heavily indebted parts of the corporate sector and in poor credit growth of public sector banks given they have inadequate capital relative to impending losses on legacy assets.

49. Corporate credit risk profile is showing some signs of improving gradually; the large distressed borrowers are being directed to the Insolvency and Bankruptcy code; and efforts are under way to concretely address public sector bank health in near future. These structural changes will revive the affected economic activity, but with a lag. Teething problems, or at least the uncertainty, facing the Goods and Services Tax (GST) rollout, should also resolve soon. In the meantime, given our inflation outlook has risen quite some distance over the target of 4 per cent, there did not seem much room for monetary policy adjustment.

50. The Reserve Bank remains committed to improving the transmission of monetary policy. I believe there is still some scope left for transmission of past monetary policy accommodation to existing loan portfolio that is tied to the base rate. Our Study Group on the MCLR has proposed what I find a reasonable path going forward in referencing floating rate loans to simple market benchmarks that will improve transparency for borrowers and competitiveness in lending. I am hopeful that switching to one of the recommended benchmarks with more frequent resets will enhance the effectiveness of monetary policy in future.

Statement by Dr. Urjit R. Patel

51. Headline CPI inflation has risen sharply in the last two months and there has been a broad-based increase in inflation excluding food and fuel. Even as the assessment of food prices going forward is generally favourable, some factors have imparted uncertainty to the near-term overall inflation outlook. Firstly, international crude prices have firmed up significantly in the more recent period. Second, global geo-political uncertainty and volatility in financial markets have increased. Third, a combination of farm loan debt waivers by state governments and the implementation of the pay commission award could entail some fiscal slippages and pose a risk to inflation. Notwithstanding some softening in the recent period, inflation expectations show downward rigidity. This is reflected in the high increase in staff cost, particularly in the manufacturing sector.

52. The loss of momentum in Q1 of 2017-18 has imparted a downside to the overall GVA outlook. The implementation of the GST has rendered prospects for the manufacturing sector uncertain in the short-term. This may further delay the

acceleration in investment activity. However, there is a need for more data to assess whether the recent headwinds in overall GDP growth prints are transient or sustained. Prospects of agriculture are favourable, notwithstanding marginally lower estimates of kharif production. The Reserve Bank's industrial outlook survey points to overall business sentiment improving in Q3. The manufacturing PMI remained in expansion mode in August and September. Output of core industries showed a robust growth in August. Several lead indicators of services sector activity – sales of commercial and passenger vehicles, international air passenger traffic, railway freight traffic, and foreign tourist arrivals – gained momentum in August. GVA growth is projected to strengthen in the second half of the year.

53. Recent structural reforms may have had some impact on growth in the short run. However, they will boost medium- to long-term growth prospects. To improve immediate growth prospects, teething troubles relating to GST need to be addressed expeditiously. Concerted efforts also need to be made to encourage investment activity by removing various constraints. Resolution of stressed balance sheets of banks remains important for supporting a revival in the investment cycle. Finally, government should adjust administered interest rates on savings instruments every quarter as per the formula to help with monetary transmission.

54. For keeping headline inflation close to 4 per cent on a durable basis, it is important to recognise near and medium-term risks to the inflation outlook. We have to be vigilant on account of uncertainties on the external and fiscal fronts; this calls for a cautious approach. I, therefore, vote for keeping the policy repo rate on hold, while maintaining the stance as neutral.

Jose J. Kattoor
Chief General Manager

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