MPC DELIVERS A PRAGMATIC POLICY IN THE MIDST OF SEVERAL UNCERTAINTIES

EXPERT VIEW

RUPA REGE NITSURE

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While the decision of the central bank's monetary policy committee (MPC) in the first bi-monthly monetary policy statement for fiscal 2019 has been along expected lines, there is a clear admission in the policy statement that inflation no longer poses a serious macro risk.

Hence, the MPC has revised downwards its projections for inflation based on the Consumer Price Index (CPI) to 4.7-5.1% for the first half of the fiscal year from the 5.1-5.6% forecast in its February policy statement, and to 4.4% from 4.5-4.6% for the second half.

Interestingly, this includes the impact of higher house rent allowances for central government employees, as recommended by the Seventh Pay Commission, which is just a statistical adjustment. After removing this statistical impact, the projected inflation range further falls to 4.4-4.7% for the first half and 4.4% for the second half.

This is indeed very comforting from the bond market perspective, as bond yields had surged by more than 120 basis points between July and March, pricing in the expectation of quickening inflation and more hawkish response from the Reserve Bank of India (RBI).

Thursday's monetary policy further strengthened the optimism created by two recent events. First, the reduced market borrowings programme of the central government for the first half of 2018-19 announced on 26 March, and secondly, "permission" granted by RBI to banks on 2 April to spread mark-to-market losses on their investment books equally across up to four quarters.

Hopefully, this would have some moderating influence on cost of borrowings from the primary bond markets, which have now emerged as the major source of finance besides the primary capital market.

This is especially important given the reduced ability of banks to undertake corporate lending as RBI's new NPA (non-performing asset) Resolution Framework, though structurally positive, will push up lenders' credit costs and undermine capital adequacy.

Even as RBI has switched growth forecasts from gross value added (GVA) to gross domestic product (GDP) in the interest of international comparability of economic performance, the MPC's expectation that India's GDP growth would improve to 7.4% in fiscal 2019 from 6.6% in fiscal 2018 appears to be highly overstated.

Recovery in India's manufacturing and services sectors is still quite weak and concentrated in a few sectors. The current high growth numbers of factory activity are illusory and primarily helped by a low statistical base as growth had significantly slowed down in the aftermath of demonetization. This trend will get normalized from mid-2018. Also, banks will have less growth capital to lend to companies under RBI's new and more stringent NPA framework and this will primarily hit the growth of small and medium enterprises whose growth is highly dependent on bank borrowings.

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Additionally, export growth has started decelerating in recent months due to several factors like delays in getting goods and services tax refunds, shrinkage of trade finance, loss of competitiveness due to overvaluation of currency and rising trade protectionism (which was mentioned by the MPC as well).

Other risks to the growth outlook highlighted by the MPC like growing fiscal indiscipline in the run-up to elections and the consequent crowding out of private financing and investment are also realistic. The usual uncertainty of the normality of monsoon and its geographic and temporal distribution will continue. Considering all these factors, it's unrealistic for the MPC to expect India's GDP growth to improve by 80bps to 7.4% this fiscal year. Even for fiscal 2018, there was a shortfall of 100bps in the actual GVA growth (as per the Central Statistics Office's estimate) and the MPC's GVA projection in the first bi-monthly monetary policy for FY18.

However, RBI's assessment of "inflation outlook" and continuation of "neutral policy stance" have sent positive signals to bond borrowers and fund-raisers. Its prompt response in the form of liquidity injection to the tune of Rs6,000 crore and Rs21,300 crore on a net daily average basis in February and March, respectively, correctly addressed the issues of slump in confidence amid growing bond market uncertainties.

Not just today's monetary policy but all the recent regulatory steps taken by the RBI clearly show that it is appropriately focusing on economic stabilisation amid growing domestic and global uncertainties. And this is obviously facilitated by a more favourable inflation dynamics on the back of improved supplies of foodgrains and perishables on the one hand, and muted demand conditions (especially in non-rural belts), on the other.

Rupa Rege Nitsure is group chief economist at L&T Financial Services.