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Monetary Policy | Regulators will focus on preserving policy effectiveness

As the RBI has succeeded in stabilising immediate economic settings, it will now play a bigger role in restoring the confidence in financial system to preserve policy effectiveness.

Rupa Rege Nitsure

The Monetary Policy Committee's (MPC's) recommendations on October 4 will take into account the following incremental economic developments after its August policy.

Global Economy — Global economic outlook continues to deteriorate with growing trade and geopolitical tensions. Major central banks, including the Fed and the ECB, have seen a renewed focus on monetary policy easing. Global cutbacks in manufacturing production have negatively impacted the prices of major commodities, such as iron ore, copper and crude oil. While global financial markets remain risk averse, the 'haven' appeal of the US Dollar has been rising.

Domestic Economy — Agriculture offers a silver lining in FY20. Monsoon rainfall is 7 per cent above the long period average; water level in key reservoirs is 21 per cent higher than the 10-year average. Kharif sowing has progressed well; sowing in paddy and pulses lags (y-o-y) but we have enough buffer stocks of rice and there is no shortfall in the main pulse — arhar.

Based on kharif sowing, cash-flow prospects of farmers are seen to be improving in Karnataka, Madhya Pradesh, Uttar Pradesh, Kerala, Gujarat, Telangana, Haryana and Punjab, provided that government's procurement machinery functions efficiently. Official assessment shows that excessive rains in 12 states may not impact the overall food grains output much. Improved soil moisture and healthy water reserves bode well for 'rabi' crops and there will be some revival of rural demand in H2, FY20.

Slowdown in India's non-agricultural sector has become more severe after the August policy, as shown by many leading indicators, such as quarterly corporate earnings, industrial and core industrial production, trade statistics, PMI prints, auto sales, financial credit, air passenger traffic, railway freight traffic, diesel consumption, cement dispatches, etc. A precipitous decline was observed in business and consumer confidence indices. Furthermore, GDP prints for Q1, FY20 too showed significant deceleration in investment and consumption demand.

Inflation — Headline CPI inflation inched up slightly in July-August due to the seasonal spikes in food inflation but remained way below the RBI's target of 4 per cent. Core CPI inflation was at a higher level (4.23 per cent) in August reflecting sharp spikes in gold and silver prices. After removing that effect, it actually crashed to 3.88 per cent — its lowest in the past two years.

Liquidity and Interest Rates — Systemic liquidity has been in surplus since June. However, the G-Sec yield curve steepened after the RBI's monetary policy announcement in August as traders remained wary of fiscal slippage due to a likely fiscal stimulus. Yet the RBI's cumulative reduction in the repo rate impacted government bonds more favourably than corporate bonds. Corporate spreads continue to remain elevated due to high credit risk perception. Even leading banks lowered 1-year MCLR by 25-40 bps against the RBI's 110 bps repo rate reduction. In short, monetary transmission has been very weak.

Fiscal Stimulus — On September 20, the government announced a fiscal stimulus worth Rs 1.45 trillion to arrest the broad-based economic slowdown by way of the corporate tax reduction. We expect this measure to improve corporate earnings only in the medium term, provided that policymakers work in coordination to remove structural constraints for both real and financial sectors.

Against this backdrop, we expect the MPC to revise downwards its real GDP growth projection for FY20 from 7 per cent in August to 6.3 per cent with a downside bias. However, we don't expect it to revise upwards its headline CPI projection for FY20 despite recent spikes on account of likely healthy growth in food grains production and broad-based weakness in demand, which may not reverse quickly. Also, ongoing global growth concerns would keep oil prices capped despite geopolitical stresses.

The recent fiscal stimulus may not be viewed negatively, as it has not given rise to additional market borrowings in H2, FY20. Also, it directly addresses the issue of low investment sentiment and competitiveness of Indian companies, which is the need of the hour.

Given that the real interest rate is still near 2 per cent, there is still a scope for an additional reduction of 35-40 bps in the repo rate during H2, FY20. Liquidity will stay in surplus as the RBI panel has recommended adoption of flexible approach on liquidity management. As the MPC has already lowered the repo rate by 110 bps since February and as the pace of transmission remains very slow, we expect it to reduce repo rate by 15 bps on October 4 and keep some buffer for future reductions. The weight of financial and regulatory measures will be higher in the upcoming policy than the monetary measures.

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