

Opinion | Inflation, growth outlook point to a rate cut in Q4

If the current trends continue, there is a strong possibility that MPC may have to reduce the repo rate in the March quarter rather than increase it

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Economic settings that guided the last monetary policy review have undergone a sea change in the past two months. Growth is faltering in several large world economies such as the US, eurozone, Britain and China amid prolonged trade disputes and tightened financial conditions. The outlook for many developing countries has turned weaker due to country-specific factors and global uncertainties.



The picture in India is also not very encouraging. The latest GDP statistics show a year-on-year contraction in mining activities and significant (345 bps) deceleration in manufacturing growth in the September quarter. Agriculture too has suffered this year due to highly skewed spatial and temporal distribution of rains and failure of minimum support prices (MSPs) to improve farmer remuneration. Based on various agrarian health parameters, one sees severe cash flow stresses in Marathwada, Vidarbha, Central Maharashtra, Saurashtra and Kutch, Gujarat region, Kerala, Assam and Jharkhand.

Food inflation has been continuously crashing after demonetisation and has fallen from an average of 5.4 percent in the pre-demonetisation period (December 2014 to November 2016) to a low of 1.6 percent in the post-demonetisation period (December 2016 to October 2018).

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Liquidity tightness and elevated costs of borrowings for NBFCs, following the IL&FS defaults in September, especially for long duration funds may prove to be a drag on economic growth. It must be noted that in the past three years, NBFCs accounted for nearly a third of incremental credit to the retail and small business segments. The growth outlook has been dampened by both short term uncertainties and pending long term structural issues, especially for public sector banks and infrastructure segments.

On the inflation front, elevated risks to inflation from oil prices and rupee depreciation too have eased remarkably between the last policy review and now, with Brent crude down by nearly 32 percent and rupee appreciating by almost 6 percent. Headline consumer price inflation -- the nominal anchor of monetary policy -- softened to 3.3 percent in October, its lowest level in the past one year and is expected to trend even lower on the back of accelerated softening in food and fuel inflation rates.

There is a heightened probability that core inflation would also moderate in tandem with weaknesses in aggregate demand as reflected in this year's lacklustre festive season sales of automobile varieties, crashing of rural CPI below 3 percent and a sharp sequential deceleration in private consumption expenditure both at current and constant prices in the September quarter as per the latest GDP statistics.

In view of the rapidly weakening demand and inflation outlook, there is a clear scope for the Monetary Policy Committee to change its stance back to 'neutral' on December 5 from the present stance of calibrated tightening. A favourable shift in macros, especially in inflation, exchange rate and liquidity (thanks to RBI's open market bond purchases) have shifted the G-Sec yield curve downwards in the last one month. Unfortunately, RBI's open market operations have largely supported gilts but not private borrowing costs.

If the current trends continue, there is a strong possibility that MPC may have to reduce the repo rate in the March quarter rather than increase it. A change in stance to 'neutral' will go a long way in restoring optimism about the financing conditions, a prerequisite to support firms' decisions to invest and create jobs.

(The author is Group Chief Economist, L&T Financial Services. Views are personal)

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