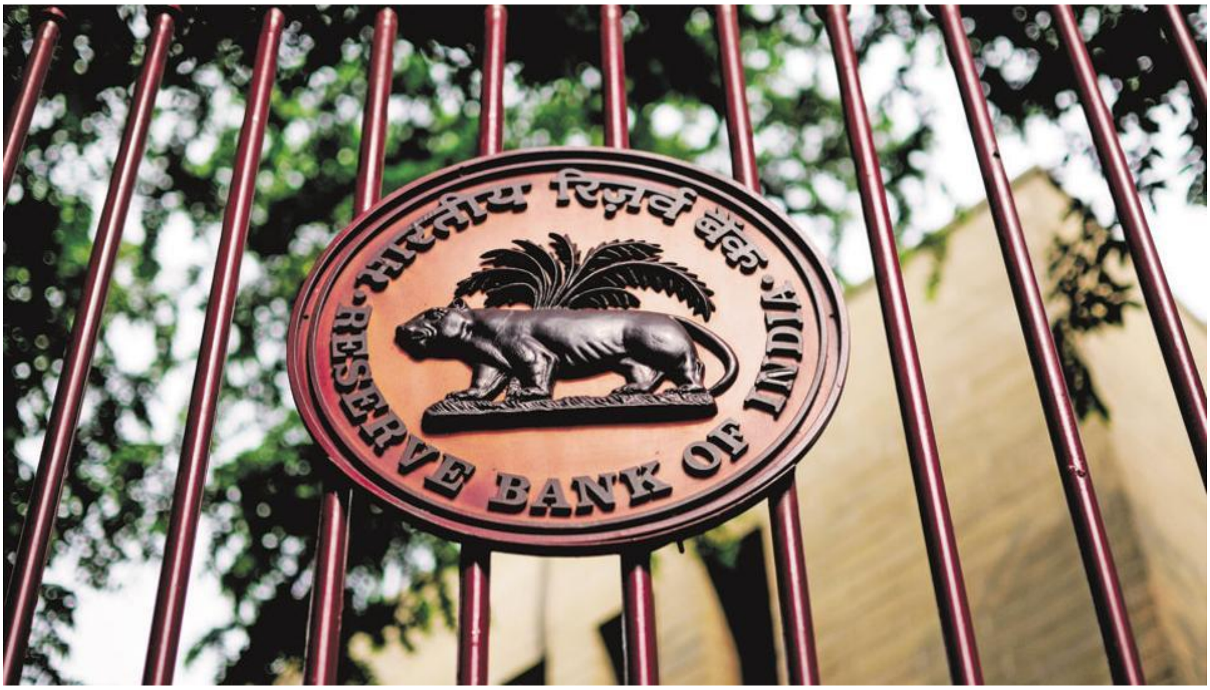
Monetary policy Implications



In the Monetary Policy Committee (MPC) Meeting held in February 2019, RBI cut the repo rate by 25 basis points from 6.5 percent to 6.25 percent. It also adjusted the reverse repo rate to 6 percent and the marginal standing facility (MSF) rate and the bank rate to 6.5 percent and kept the CRR unchanged at 4 percent. The MPC has also changed its policy objective from calibrated tightening to neutral. This signifies that now the RBI has moved from the rate hikes towards a possible indication of further rate cuts in the upcoming MPC meetings. MPC voted 4:2 in favour of rate cut but were unanimous on change in stance. The RBI estimates are as follows – Headline inflation estimates revised down to 2.8 percent in March quarter, 3.2-3.4 percent in first half of next fiscal and 3.9 percent in Q3 of FY'20. It has also Projected GDP growth to accelerate to 7.4 percent next fiscal, from 7.2 percent in 2018-19 and has pegged April-September growth in range of 7.2-7.4 percent, and 7.5 percent in Q3 of 2019-20. What does the change in policy stance signify? What are the policy rates cut implications and what can be expected from the MPC in the upcoming meetings? Let' s deep dive into the subject and see what lies ahead.

We are aware that RBI's monetary policy objective is to maintain a proper balance between real GDP growth and inflation but most importantly to bring inflation under control as it is clear from the perennial speeches of all the central bank governors. In the Indian context, the recent policy rates cut signify that the inflation rate in the last couple of quarters has been under good control with it hovering around 2.5-3.5%. However, it has been observed that in the last 2 quarters the growth has become subdued though primarily from the unfavourable base effects with the GDP growth in the range of 6.3-6.7% in the last 2 quarters. MPC had taken a calibrated tightening stance in the last couple of meetings because of the spiralling oil prices and depreciating rupee which was expected to have an adverse effect on inflation as these 2 indicators were in uncertain territory. But, over the last quarter or so we have seen that oil prices have come down and rupee has also been under control and in fact appreciated albeit to a marginal degree. The coupling effect of the stability of these two key determinants which have a considerable impact on inflation has played a critical role in keeping both headline and core inflation under control. The key component in the headline inflation in Indian context which are the food prices have been depressed over the last quarter or so and this has helped in keeping the headline inflation low and stable. Hence, a decline in the growth rate in GDP from 7-7.25% to 6.3.-6.7% coupled with low inflation caused RBI to change its stance from the calibrated tightening to neutral. This is appreciative because post the demonetization and GST impact, the world's fastest growing economy needs an ammunition to sustain to its earlier levels of 7-8%+ levels of GDP growth and the rate cuts or the maintenance of them can play a critical role in doing that.

Now, what lies ahead for RBI, how can it ensure that the growth and inflation balance is maintained. Firstly, it should be noted that the RBI's policy stance, as it has been observed from the MPC meetings, indicates clearly that it is based on forward looking statistics of growth, headline and core inflation, oil prices and rupee exchange rate. So, making accurate forecasts for a period exceeding 6 months for the aforementioned indicators and determinants thereof is difficult. Therefore, since it can be reasonably estimated that the inflation is unlikely to breach the RBI's target of 4-5% and since the growth can also be volatile in light of the upcoming elections, RBI may look at another rate cut in the MPC meeting in April. This will provide some cushion for the economy ahead of the election results and the full year budget which will be presented in July. However, it is to be noted that this takes into consideration a critical assumption that the oil prices don't rise significantly, or Rupee doesn't depreciate adversely till the next meeting in April. After that, when the next meeting happens in August, RBI will have a bit more clarity in terms of what the inflation would look like 6 months from then, what will be the government's fiscal position based on full year budget, and the growth projections of the new government likely to be formed. These will help RBI take a more stable outlook rather than transitioning their stance from one meeting to another as it creates uncertainty in the economy and creates volatility in securities markets.