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INDIA TESTS GDP NEGATIVE: NOW, RESERVE BANK NUDGES ECONOMY FURTHER

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

RBI governor announces a 40 bps cut in repo and reverse repo rates, while pivoting the regulator’s focus from inflation control to fostering growth

The Reserve Bank of India (RBI) delivered an emergency rate cut for the second time in as many months on Friday as it judged that the coronavirus pandemic poses a grave threat to the country and will lead to the first economic contraction in 40 years.

Central bank governor Shaktikanta Das took to YouTube on Friday to announce a 40 basis points (bps) cut in repo and reverse repo rates, while markedly pivoting the central bank’s focus from inflation control to fostering growth. Das pledged to take whatever “measures are necessary" to meet the challenges posed by the pandemic.

The monetary policy committee’s (MPC’s) shift of focus to reviving growth, prompted by the severe economic stagnation, is borne out by its emphasis on smoothening transmission of lower rates and improving industry’s access to working capital, elongating the borrowers’ repayment curve to ease debt servicing stress and relaxing asset classification norms.

“It is in the growth outlook that the MPC judged the risks to be gravest. The combined impact of demand compression and supply disruption will depress economic activity in the first half of the year," governor Das said in a statement.

The MPC voted five to one in favour of the 40-bps cut in benchmark rates, with member Chetan Ghate voting for a 25-bps cut.

Economists expect more such cuts. Rahul Bajoria, chief India economist at Barclays Bank, said he expects an additional 50 bps of rate cuts, most likely to be delivered by end-June or early July. “This keeps our projection of terminal repo rate at 3.50%, with risks clearly biased towards rates going further lower," said Bajoria.

In another departure from established practice, the central bank refrained from providing a gross domestic product (GDP) growth forecast for the year, or the likely trajectory for inflation. “Given all these uncertainties, GDP growth in 2020-21 is estimated to remain in negative territory, with some pickup in growth impulses from H2: 2020-21 onwards," governor Das said.

Das noted that monetary policy transmission to banks’ lending rates has continued to improve and the one-year median marginal cost of funds-based lending rate declined 90 bps between February 2019 and 15 May 2020. This comes at a time when credit growth is declining as borrowers shun new loans and instead look for repayment deferment on existing debt.

The markets sent mixed signals in response to the RBI rate action. The equity markets displayed its disapproval with the benchmark Sensex losing over 260 points at closing. However, bonds rallied with yields on the benchmark 10-year sovereign bonds falling 7 bps to close at 5.96%. The rupee closed at 75.96 a dollar, 0.44% weaker than its previous close.

The governor and the MPC painted a grim picture of the economy.

According to Das, domestic economic activity has been severely impacted by the ongoing lockdown. The top six industrialised states that account for about 60% of industrial output are largely in red or orange zones. Noting that demand has been severely impacted, the governor pointed out that the biggest blow from covid-19 has been to private consumption, accounting for about 60% of domestic demand.

“Amid this encircling gloom, agriculture and allied activities have provided a beacon of hope on the back of an increase of 3.7% in foodgrain production to a new record," said Das.

The monetary policy committee, Das said, feels that headline inflation may remain firm in the first half of FY21 but should ease in the second half, aided also by favourable base effects. By the third and fourth quarters of the current financial year, the MPC expects that the headline inflation will fall below the target of 4%.

“Thus, the forward guidance of the MPC is directional rather than in terms of levels. Going forward, as and when more data are available, it should be possible to estimate the path of inflation with greater certainty," he said, adding that the inflation outlook has become complicated by the release of partial information on the Consumer Price Index (CPI) by the National Statistical Office (NSO), obscuring a comprehensive assessment of the price situation.

The MPC believes that the macroeconomic impact of the pandemic is turning out to be more severe than initially anticipated, and various sectors of the economy are experiencing acute stress.

Given the economic compulsions and the unfolding financial and economic stress, Das said RBI’s goals are to improve liquidity in the financial system, ensure smooth functioning of financial markets, to deepen financial inclusion and to preserve financial stability.

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