# A hold on rate cuts, citing multiple risks; transmission sought to be improved

The Monetary Policy Committee (MPC) decision should have been a close call, the current risks being evenly balanced, and the outcome could have gone either way for a hold or a cut in the repo rate. Thereafter, the decision by the Centre on Tuesday to provide a (moderate) fiscal stimulus by cutting taxes on fuel, must have slightly shifted the MPC discourse. The choice now would have been to reinforce the fiscal stimulus with a rate cut or to wait and assess the effectiveness of the various policy measures either currently in play or proposed. Clearly, not only was the latter alternative deemed more appropriate, it emerged that the assessment risk was of greater concern than expected.

The decision to hold the repo rate (although the statutory liquidity ratio was cut by 0.5%) seems to have centred around three metrics, in order to “carefully manage … the juxtaposition of risks”.

First, growth. There is a recognition of a slowdown (to a forecast 6.7% in FY18), particularly significant in the June quarter, and this would likely have been worse but for the cushioning of high government spending. Survey indicators like consumer confidence and business assessment of manufacturing and services sectors also remained weak, although business is expected to improve in the October quarter. In addition, the 7th Pay Commission hikes might boost household consumption. But this is by no means certain: the possibility of the “output gap” widening—indicating worsening capacity utilization—remains a possibility, keeping pricing power of companies low, adversely impacting corporate profits, thereby further reducing the gross value added (GVA). However, supply bottlenecks and goods and services tax (GST) implementation glitches are likely to be resolved relatively quickly.

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Second is inflation. Although the path of CPI prices increases over the course of the year, much of this is due to a “statistical top-up”, generated by the one-time implementation of the Pay Commission salary and allowance increases. Our own estimation is that the inflation trajectory is likely to rise well into FY19 as well, as states begin their own version of Pay Commission-related hikes. There are signals, both from this policy and before, that the MPC will be prepared to look through this.

Moreover, although MPC is sanguine about government’s ability to manage food prices, they are more concerned about the “generalized momentum” in non-food prices, particularly due to rising fuel prices.

Third, the general government deficit, both of the Centre and states. In particular, the policy statement and the follow-up interactions highlight the risks of fiscal laxity by states as the aspect of primary concern, with the risk that this might add to the momentum of rising non-food prices.

Overlaid on all of the above concerns is India’s external environment, with the prospect of heightened volatility and capital flows following global central banks’ rate and balance sheet taper actions. How this volatility interacts, presumably through a weaker exchange rate, with domestic inflationary forces, opens up yet another degree of risk for RBI.

The tone of the policy statement on the developing risks seems more hawkish than expected in the current weak growth environment. First, the composition of MPC voting, indicating the evolution of the collective assessment of risks, is less accommodative than the previous policy. Second, the presumed growth–inflation trade-off is likely to be disturbed by both domestic fiscal slippages and global factors, imparting greater uncertainty to the policy actions.

In addition, the statement reiterated the impediments to effective transmission of monetary policy

easing. A change in bank loan pricing methodology, shifting away from the MCLR (marginal cost of funds based lending rate) and particularly the base rate to a market benchmark-linked lending rate has been in the pipeline. In fact, one of the factors driving the markets expectation of a hold in this review was that the change would be announced prior to future rate cuts. As of writing, we await the discussion paper on the proposed alternatives.

So what might now be the trajectory of easing going forward? Given MPC's assessment of the economic environment, the evolution of the key risks and macro variables will obviously shape thinking. However, the crucial factor in the decision will be the role of monetary policy amidst the likely progressive roll-out of fiscal, trade and industry policy measures. The extent to which these measures are deemed to be process de-bottlenecking ones and designed to increase productivity, might open up space for further rate cuts.

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