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ACCOMMODATIVE STANCE INDICATES POLICY RATE COULD GO BELOW 5% HANDLE

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

Current growth slowdown is a combination of cyclical, durable and structural factors

With the markets and the analyst community almost unanimously expecting a rate cut, the focus of the monetary policy was on the quantum of the cut, as well as the governor's speech. Though a reasonable section did expect a 40 basis points (bps) cut, the overall outcome did not disappoint. The sharp downward revision in gross domestic product (GDP) from 6.9% to 6.1% and the explicit accommodative guidance were the key highlights of the policy. Given the extent of the downward revision in GDP, one would have possibly found a 50 bps rate cut more consistent, but the large fiscal stimulus from the government, the narrowing real rates to recent lows and the necessity to get better transmission of past rates probably led them to be a little conservative.

The significant change in this policy was of course the provision of an explicit forward guidance on the back of worsening output gap and comfortable inflation. The statement specifically says that "there is policy space to address these growth concerns", and the RBI governor in his post-policy communication further reinforced this by saying that it should be viewed as a form of forward guidance. Additionally, comfort was also given that the accommodative stance would continue as long as "necessary to revive growth" indicating more room. Since we too hold a similar prognosis about growth, we believe the policy rate could move below the 5% handle.

On the growth front, the accompanying monetary policy report presents analysis, which shows that the output gap has turned more negative over the past quarter, and concerns were raised about private consumption, which is slowing down due to a host of reasons. The weak performance of employment-generating sectors, such as automobiles and real estate, were also highlighted. We believe the current growth slowdown is a combination of cyclical, durable and some structural factors. Fiscal and monetary policy are acting in concert to alleviate the slowdown, but substantial pickup in growth could still be a little time away. The RBI's CPI projection of 3.5-4% for FY21 also lends a lot of comfort to the sustainability of this rate cut cycle, barring any adverse shocks that may emanate from the global economy or markets.

On the liquidity situation, our forecasts suggest that for H2, systemic liquidity will remain ample though festival season currency leakage would dent this surplus. Our confidence in the liquidity surplus forecast arises on account of moderation in economic activity leading to a lower run rate of currency leakage and a higher balance of payments surplus. Expectations of open market operations will be scaled down even though the governor did provide comfort to the market that all tools, including OMOs and buy-sell swaps, remain.

We expect the sovereign curve to continue to steepen with the 'up to 4 year' segment remaining well supported on account of lower funding cost and ample liquidity, while the long end fluctuates to the borrowing programme. Corporate spreads for better rated entities in the short end could compress with liquidity staying ample. The recent cuts in corporate taxes will also lead to healthier balance sheets and, in time, improve the outlook on credit papers for good entities. Given that both monetary and fiscal easing are underway, we expect the rupee to stay under some mild depreciation pressure, although a better-than-expected BoP surplus will provide some buffer.

On the regulatory front, acceptance of two of the recommendations laid out by the task force on offshore rupee markets is a welcome step. For these objectives to be realized, it is imperative that the other recommendations of the committee, such as market time extension, be also looked into at the earliest, along with the issuance of the foreign exchange hedging guidelines, which liberalizes the onshore market in terms of documentation, product suite for offshore participants and, thereby, incentivise them to participate in onshore markets.

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