Brickwork Ratings' expectations from RBI MPC's August meeting

- ***Retain policy repo rate at 4%***
- ***Continue with accommodative policy stance***
- ***Change in FY22 inflation outlook***

The Monetary Policy Committee (MPC) of the RBI has kept key policy rates unchanged since May 2020, after having brought them down to a record low of 4% from 5.15% through two rate cuts (75 bps in March 2020 and 40 bps in May 2020), to assuage the economic consequences of the Covid-19 pandemic. Moreover, the MPC has continued with the accommodative policy stance after changing it from neutral to accommodative in June 2019. In addition, to enable the smooth functioning of financial markets, the RBI announced additional liquidity boosting measures such as OMOs, G-saps, forex swaps, TLTROs and sector-specific measures.

Brief economic scenario and outlook

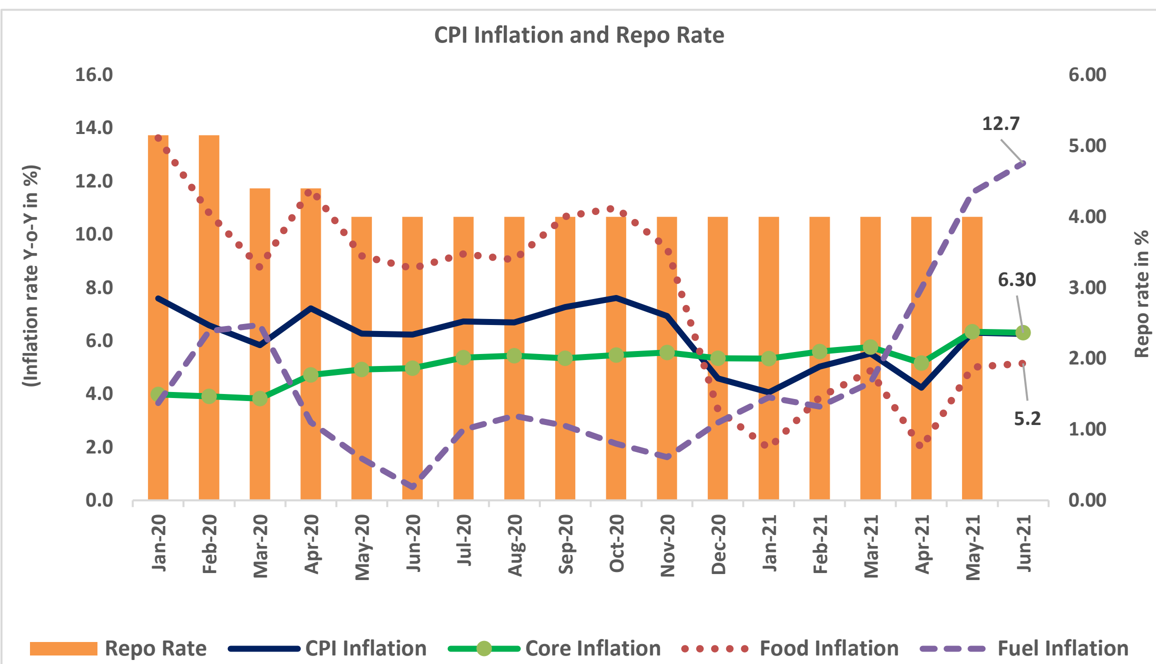
The lethal second wave brought recovery process to an abrupt reversal, though, as compared to last year's levels, disruptions on economic activities were lesser because the restrictions imposed this time were selective and partial. Yet, there were curbs on consumer demand and supply chain disruptions as a result of selective lockdowns and traffic bottlenecks. The impact of the second wave and lockdowns is reflected in the reduction in the manufacturing and services PMI; both plunged below the 50-mark in June 2021, and sequential decline was recorded in the index of industrial production and eight core industries, which reported 8% and 4.1% contractions, respectively, in their production in May 2021 over April.

During the first quarter of the current fiscal, (Q1FY22) almost all the states had followed containment measures after the sharp and swift rise in the spread of the virus. Considering the severity of the pandemic, many domestic and international agencies revised the growth projections downwards from double digits to a single digit. The second wave of Covid-19 in India is assumed to have been more severe than the first wave, and the situation had intensified due to poor healthcare facilities. Surely, the pandemic toll on the economy has been huge so far, and the RBI too, in its June MPC, revised the full-year GDP projections to 9.5% from 10.5% growth projected in its April MPC. For Q1FY22, the RBI expects GDP growth of 18.5%, which has been revised downwards from the earlier estimates of 26.2%. BWR also revised the GDP projections for FY22 to 9% (year-on-year) from 11% estimated in January 2021. Due to a negative base effect, Q1FY22 GDP growth is expected to be at 14% (the GDP contracted by 24.4% in Q1FY21).

Given the fall in new cases since mid-May, the impact of the second wave is likely to be confined to Q1FY22 and the subsequent quarters will see an improvement if there is no resurgence of the virus in the form of a third wave. Progress recorded in the vaccination drive so far and improved health infrastructure will provide major relief to deal with any future waves of the pandemic. With the easing severity of the second wave of the pandemic, many states have started relaxing restrictions, but economic activities have not revived completely to their pre-pandemic levels. The nascent sign of recovery seen in most growth indicators on a year-on-year basis is largely due to negative base numbers and was also supported by pent-up demand. The past fiscal and monetary stimulus measures have played a significant role in lifting the economic mood.

Rising inflation outlook- a major challenge for the MPC

The RBI has continued to assure markets of the availability of adequate liquidity since the beginning of the pandemic, and the government has also provided significant support through credit guarantee schemes to revive Covid-hit sectors. However, the government does not have much leeway on the fiscal front; there is not much the RBI can do either, in the prevailing situation. The system is flush with liquidity, and the lurking fear of a surge in inflation restricts further monetary accommodation. Since the last MPC meeting, core, food and fuel inflation in the CPI index have increased sharply. The consumer price index (CPI) in June remained above 6% at 6.26%, which is close to 6.3% reported in May. Core inflation, which continued to remain above 5% since June 2020, has moved above 6% in May and June 2021. An upsurge in crude oil prices is also posing fuel inflationary threats, in addition to a rise in the prices of some items of food segments. The transient effect of the input cost pressure emanating from rising commodities and supply constraints was already reflected in the 12% average WPI inflation during the April to June 2021 period.



Note: Data is provisional. Core inflation excluding food and fuel.
Source: MOSPI, RBI, BWR Research

CPI inflation crossing the upper target of 6% in two consecutive months is a major challenge for the MPC to be able to continue with the accommodative stance. Rising fuel inflation on account of the increasing international price of crude oil in the wake of rising global demand conditions, sticky core inflation levels at above 6%, an increase in food inflation due to rising transport costs and import prices altogether pose a serious threat on price stability and can also pose an upward risk to inflation with excess liquidity floating in the system. First quarter (Q1FY22) inflation has already breached the RBI's inflation outlook by 40 basis points to 5.6%. The cost push factor due to fuel inflation is particularly challenging. With this, the inflation outlook of 5.1% for the full fiscal by the RBI looks difficult. Going forward, with the lifting of the lockdown in phases, domestic demand conditions are expected to improve gradually, and this may lead to a further increase in prices. However, the RBI seems to think that inflationary pressure is mainly due to supply factors, and the lifting of restrictions will ease constraints to ease inflationary pressures in Q2. Therefore, we expect the MPC will continue its accommodative stand and is unlikely to change the policy rate in its August policy meeting. It may, however, state that the inflationary situation would be watched closely in the coming months.

The emphasis to nurse economic recovery and to revive growth will continue hence inflationary concerns are not likely to play out. Despite the inflation rate surpassing the upper range of the target and surplus liquidity in the market, MPC members had unanimously voted to keep policy rates low to support growth momentum in the previous policy meeting. We do not see any change in the forthcoming meeting from this stance, though the MPC may assure markets that the inflationary situation will be closely monitored.

We expect the RBI MPC to hold the repo rate at 4% and continue to be accommodating to support the nascent recovery, in the upcoming MPC. We also expect it to sound a cautionary note and emphasise the need to closely monitor the situation.

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