Uncertain Economic Challenges: MPC expected to cut repo rate to prop-up sentiments; more sector-specific measures remain need of the hour

Brickwork Ratings, Mumbai, 26 March 2020: COVID-19 has posed the mother of all challenges. Besides containing the spread of the virus and protecting people’s lives, the government has to provide to sustain livelihoods by ensuring adequate liquidity and making cash transfers. It is not clear how long this problem will last; as and when the pandemic recedes, there would be major challenge of reconstruction. Meanwhile, in keeping with the promise of the RBI Governor that the RBI will do whatever it takes, it is reasonable to expect a sharp reduction in the borrowing costs.

Economic uncertainty due to the COVID-19 pandemic has called for an immediate rate cut by the RBI’s Monetary Policy Committee (MPC) as there is a fear that the domestic economic fallout would escalate. Supply disruptions arising from the country-wide lockdown as a precautionary measure to contain the disease spread will pose additional challenges to several sectors of the economy.

Amid these adverse developments, there is a heightened expectation of fiscal and monetary stimulus by the RBI and government. It is now widely believed that the extreme situation needs to be encountered by ensuring easy and cheaper liquidity along with the government easing its purse to protect vulnerable sections. There is a high expectation that the RBI would cut the rates in its scheduled meeting on 3 April 2020, if not before, particularly after the unprecedented rate cuts by almost 40 countries, including the US and England. It is not the question of whether there will be a cut; the question is by how much. In the new MPC regime, changes in rates have to be made by the committee and therefore, the decision of the committee will be keenly watched.

In a press conference held by the RBI on 16 March, the RBI gave enough indications of an easy monetary policy, but did not announce policy rate cuts. Instead, it announced an additional rupee-dollar swap and Long-Term Repo Operations (LTRO) to ensure adequate liquidity in domestic markets. Following these announcements, we expected more such measures by the RBI. Accordingly, in line with our expectations, the RBI continued with its liquidity infusing tools such as Open Market Operations (OMOs) and term repos, mainly intended to calm the ruffled foreign exchange and financial markets. Time and again, the RBI has assured in its press
communications that it will calibrate its operations to meet the need for additional liquidity support and preserve financial stability. Despite all these assurances, mayhem continued to prevail in financial markets, and the rupee depreciated to Rs 76 per USD on 24 March (from Rs 72 on 1 March), and 10-year G-sec yields spiked to 7% levels. In addition, the event of stock markets hitting their lower circuits twice in a span of 10 days sums-up the existing economic and financial market uncertainty.

Undoubtedly, the clamour for a rate cut is at its peak, and there is an uproar for a huge reduction in the repo rate as well as cuts in the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). However, in the current situation, a rate cut cannot be expected to arrest contraction in demand, but it is largely intended to help boost or uplift sentiments and enable cheaper working capital. Amid inflation showing certain signals of moderation, the MPC of the RBI is most likely to cut the policy repo rate at least by 50 basis points in the coming days. After reaching a 68-month high of 7.59% in January 2020, CPI inflation eased to 6.58% in February, but still remains above the RBI’s comfort zone. However, the inflation rate is expected to fall below the 6% level in March amid crude oil prices crashing below USD 25 per barrel recently, providing the much-needed cushion for the MPC to adhere to the monetary policy framework.

We expect the RBI to continue with its liquidity infusing tools such as OMOs, forex swaps and LTROs, but also to announce measures to support corporates suffering from business losses due to the pandemic outbreak. As the ongoing slowdown will drastically impact the financial health of many sectors, we expect the RBI to introduce forbearance measures towards the most affected or stressed sectors, and extend the repayment schedule and moratorium, along with implementing other measures, to avoid large NPAs and reduce risk weights. This will be in addition to the measures announced by the Union Finance Minister on 24 March. A direct impact on the entertainment, tourism, hotel, restaurant and airline industries is already evident, but sectors that suffer an indirect impact of supply chain breakups need to be identified and rescued with timely support to avoid long-term damage to the economy. The RBI has a number of weapons in its armoury and likely to deploy them with appropriate force in a calibrated manner.

On the growth front, the Q3 FY 20 GDP estimate does not provide much cheer, as it continued sliding further and is estimated to grow at 4.7%. Currently, the rural economy is largely immune to the ongoing pandemic, and hence, a lot of the economic activities are unaffected. However, the services sector, which accounts for more than half of these economic activities (55% of GVA) has been badly bruised. The manufacturing sector, which is already in recession with two
successive quarters of contraction, will also be severely hit by the country-wide lockdown. The consequences of the unprecedented spread of the COVID-19 pandemic are yet to be sized up. In any case it would now be futile to continue with the expectation of 5% growth for the whole year. Even in the best case scenario, Q4 growth is not likely to be higher than 3% in the wake of massive loss in economic activity due to 21-day lockdown. Thus, swift and well-crafted stimulus from the government is warranted. The huge reduction expected in the import bill, supported by the drastic fall in oil prices, which enhances additional scope for the same. Moreover, the time is ripe for loosening the government’s kitty and doing away with the fiscal deficit target by another 0.5 percentage points or more as there is an urgency for reviving economic sentiments.

In the catastrophic situation, calibrating macro policies to revive economic sentiments is a major challenge, but is also a necessity. More than a rate cut, the need of the hour is sector-specific stimulus by both the government and RBI. Perhaps, the time is opportune for the government to ease its purse, without bothering much about containing fiscal deficit. In any case, the under-realisation of tax revenues and disinvestment from the revised estimates will force a larger deficit, but it would be unwise to curtail expenditures to contain the deficit at this juncture. It is not clear how long the pandemic will last, and if there is containment within the 21-day lockdown period, in large parts of the country, the economy may recover. In any case, the outlook for the next year is not likely to be robust, and our optimistic projection would be 4.5-5%, much lower than the earlier estimate of 5.5-6%, with a downward bias. As mentioned above, it is too early to assess the extent of the damage on the economy through domestic channels of supply disruption, production and consumption. Hence, we expect the RBI to continue with accommodative monetary policy actions and stance; and cut the repo rate by 50 basis points.

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