Sanguine economy can still do with a rate cut boost

Brickwork Ratings, Bangalore, 1st October 2019: *BWR expects 25 basis points rate cut in the ensuing RBI MPC. The international economic scenario post Federal Reserve's rate cut and our government's efforts to push the growth momentum and subdued inflation are fertile arenas for a rate cut.*

The government announced measures to boost growth, like reversing surcharge on foreign portfolio investment, changes in FDI policy, GST rate cut and restructuring the corporate tax regime. However, a steep cut in the corporate tax rate from 35% to 22% conditional on not availing tax concessions, is expected to result in a revenue loss of Rs 1.45 lakh crore. As the inflation rate is expected to be lower than the mid-point in the target range of 4%, the rate cut is not only needed but becomes feasible. The MPC with another rate cut can help to revive consumption demand and private investment.

The MPC had maintained an accommodative policy stance since June 2019 and has reduced the key policy repo rate by 110 basis points cumulatively beginning February 2019 as inflation rate remained benign. Though recent spike in vegetable prices and volatile fuel prices kept the outlook tentative, it is not expected to breach the target band of 4% till the Q4 FY20. However, the MPC will have to take a considered decision taking into account the possible slippage and uncertain global economic environment with trade tensions and geo-political risks. The reduction in the corporate tax rate witnessed a significant hike in the government bond yields due to fear of fiscal slippage. In the first five months itself, the fiscal deficit has touched 78.7% of the target. Although the Rs 2.68 lakh crore borrowing announcement for H2 FY20 signals adherence to the fiscal targets, it is quite possible to announce additional borrowing later in the year. Hence, a 25 bps cut would be in the safe zone without further straining the fiscal.

The transmission of the rate cuts which has remained a challenge so far is likely to be resolved with RBI making it mandatory for banks to link all new floating rate personal or retail loans and floating rate loans to MSMEs to an external benchmark effective October 1, 2019. After the 35 bps rate cut in August policy review, major banks have reduced their marginal cost of lending rates (MCLR) by 10 to 25 bps, which is a positive sign. Considering the poor transmission of rate cuts and the lag effect of the impact of the monetary policy on the Indian economy BWR had advocated frontloading the rate cut by 50 bps in the August policy. However, government has already loosened its purse on the fiscal front hence more than 25 bps rate cut at this juncture looks risky.

RBI may continue with its accommodative stance as current level of benign inflation also supports this. While, the quantum of the rate cut may vary this time, but ***BWR expects 25 basis points rate cut in the upcoming meeting of MPC*** *to revive private investment activity and to drive demand ahead of festive season.*

Contacts:

Dr M Govinda Rao
Chief Economic Advisor
+91-080-40409940
govindarao.m@brickworkratings.com

Anita Shetty
Research Editor
+91 22 28311426
anitashetty@brickworkratings.com

Investors and Media Contact
investordesk@brickworkratings.com
+91 77388 75550

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