MPC to maintain status quo; GDP to rebound in next fiscal

Brickwork Ratings, Mumbai, 04 February 2020: Even as there are expectations of a moderation in inflation from the elevated level of 7.35% in December 2019, the Monetary Policy Committee (MPC) of the RBI is likely to maintain the policy repo rate at 5.15% in the upcoming monetary policy meeting to be announced on 6 February 2020. We anticipate the slump in GDP growth has bottomed out to 5% in 2019-20 and expected to rebound in 2020-21 to 5.5-6%, aided by the government measures and the transmission of past rate cuts.

The RBI MPC considers CPI inflation for its monetary policy actions and inflation is expected to be within the comfort zone of the MPC in the next fiscal. However, fiscal deficit has not only breached the target, but is budgeted at 3.5% for 2020-21; including the reported off-budget liabilities, it works out to 4.3%. The breaching of the fiscal deficit target by 0.5 percentage points (from previous budget estimates) for both, the current fiscal, as well as the next, is likely to weigh in on the MPC decision. The CPI inflation crossed the MPC’s upper band target in December 2019, for the first time since the MPC was formed.

After remaining in a benign phase for quite a long period, the December 2019 inflation reached a 5-year high at 7.35%. Even as the inflation is likely to moderate in the wake of easing vegetable and fruit prices, which was the main cause of a high inflation rate in December, the MPC is likely to adopt a cautious approach, particularly after the high fiscal deficit including the off-budget liabilities. A high food inflation may continue for the next two-three months, and we expect the inflation to continue to remain above the MPC’s comfort zone at least in the current fiscal.

The MPC, no doubt, faces a serious dilemma with its commitment to control inflation and manage growth. The slump in real GDP growth warrants accommodative monetary policy actions and stance, whereas the upturn in headline inflation for the fifth consecutive month calls for a cautious response, or at least to maintain a status quo at this juncture. Despite the fiscal slippage and mounting inflationary pressures, the MPC cannot undertake monetary tightening in the current cycle, given the weak growth scenario. The inflation rate has already exceeded the MPC’s upper bound target, and going by the MPC’s monetary policy framework, there is little room to continue with the accommodative monetary policy stance as well. Brickwork Ratings expects the MPC to continue with the accommodative policy stance presently, as the slump in real GDP growth warrants it. On the GDP growth front, we continue with our estimate for 2019-20 at 5%, given some pickup in the macroeconomic indicators.

Since February 2019, MPC has cut the repo rate in five successive policy meetings and reduced the rates by 135 basis points, cumulatively. The past rate cuts began to get transmitted by the banks to borrowers recently as evident from the declining trend in banks’ marginal cost of lending rates. Further, given the early signs of rebound in macroeconomic indicators such as positive IIP and eight Core sector performances, coupled with the Manufacturing PMI scaling to a near-8-year high of 55.3 in January 2020,
growth likely to rebound in the next fiscal; we expect GDP growth of 5.5-6% in 2020-21. The Economic Survey 2019-20 has estimated 6-6.5% real GDP growth for the next fiscal. Our GDP growth estimate is constrained because of geo-political risks and an expectation of a slow turnaround expected in some key sectors currently under stress.

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